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Supreme Court of the United States

OCTOBER TERM, 1977.

No. 77-814

HEIZER CORPORATION,

Petitioner,

vs.

PETER WRIGHT, BENEFICIAL STANDARD CORPORATION AND IDC SERVICES, INC.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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PETER WRIGHT, BENEFICIAL STANDARD CORPORATION AND IDC SERVICES, INC.,
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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioner Heizer Corporation respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in this action on September 9, 1977 insofar as it imposes liability upon and mandates injunctive relief against Heizer Corporation.

OPINIONS BELOW

The opinion of the Court of Appeals is officially reported at 560 F. 2d 236 and is printed in the appendix to this petition, together with the order of the Court of Appeals.* (A3-A40)

* In footnote 1 of the Court of Appeals' opinion it is indicated that the record references contained in the Slip Opinion will not be reprinted in the permanent edition of Federal Reporter 2nd. The complete Slip Opinion is reprinted herein.

The principal opinion of the United States District Court for the Northern District of Illinois, Eastern Division, is officially reported at 411 F. Supp. 23 and is reprinted in the appendix hereto. (A42-A66) The decree which was entered by the District Court in accordance with that opinion is reprinted in the appendix hereto (A67-A70), together with an additional opinion rendered by that Court on May 28, 1976, not officially reported* (A71-A77), and an injunction pending appeal, which was entered by the District Court on June 18, 1976. (A78-A79)

JURISDICTION

The judgment of the United States Court of Appeals for the Seventh Circuit sought to be reviewed was entered on September 9, 1977. The Court of Appeals originally issued an opinion on June 30, 1977. Heizer Corporation filed a timely petition for rehearing. On September 9, 1977 a modified opinion was issued and an order was entered denying the petition for rehearing except to the extent that any relief requested in that petition was granted in the modified opinion. (A41) This Court's jurisdiction is invoked under 28 U. S. C. § 1254(1).

QUESTIONS PRESENTED

1. Whether in an action for alleged violation of Rule 10b-5 the "scienter" requirement of *Ernst & Ernst* v. *Hochfelder*, 425 U. S. 185 (1976), is met where defendant (a) acted on a reasonable belief that full disclosure of all material facts had been made and in good faith reliance on independent counsel, or (b) committed at most a breach of fiduciary duty actionable under state law.

2. Whether vicarious liability for another's violation of Rule 10b-5 may be predicated only on the express provisions of the federal securities laws governing liability of controlling persons.

* As printed herein, that opinion reflects corrections entered by the District Court in its order of July 2, 1976.

3. Whether the deception necessary to sustain a claim under Rule 10b-5, as held by *Santa Fe Industries, Inc.* v. *Green*, 430 U. S. 462 (1977), can be determined solely from a breach of fiduciary duty actionable under state law.

4. Whether compensatory relief for a violation of Rule 10b-5 is limited to damages or rescission, or may extend to the restructuring of a securities transaction.

5. Whether prospective injunctive relief for a violation of Rule 10b-5 may be imposed in the absence of findings of irreparable harm and an inadequate remedy at law, as required by *Rondeau* v. *Mosinee Paper Co.*, 422 U. S. 49 (1975).

6. Whether it is proper for a Court of Appeals to make findings of fact based on a *de novo* review of the trial record when the District Court failed to make relevant findings and the governing legal principles were substantially changed by this Court after the District Court rendered its decision.

STATUTE AND RULE INVOLVED

Sections 10(b), 20(a) and 29(b) of the Securities Exchange Act of 1934, 15 U. S. C. §§ 78j(b), 78t(a) and 78cc(b), and Rule 10b-5, 17 C. F. R. § 240.10b-5, are set forth in the appendix hereto. (A1-A2)

STATEMENT OF THE CASE

1. Introduction

This derivative suit was initiated by minority stockholders of IDC Services, Inc. ("IDC"), a Delaware corporation (formerly International Digisonics Corporation), under Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U. S. C. § 78j(b), and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission, 17 C. F. R. § 240.10b-5.* Plain-

* Petitioner is not a party to the sole non-derivative claim maintained by one of the plaintiffs.

tiffs below (respondents here) are Peter Wright, a holder of a small percentage of IDC common stock, and Beneficial Standard Corporation ("Beneficial"), the second largest common stockholder of IDC.

Petitioner Heizer Corporation (a defendant below) is a venture capital corporation which specializes in high-risk investments in newly-formed companies. Though never a holder of IDC common stock, Heizer Corporation is and has been the principal investor in IDC, contributing more than 80% of IDC's capital.

Jordan Ross ("Ross")—a lawyer, accountant and the largest common stockholder of IDC—organized Talent & Residuals ("T&R") in 1962 and IDC in 1968. Until June of 1972, Ross served as chief executive officer of IDC. T&R is an established and successful company which provides the accounting and payroll services necessary for the payment of proper "residuals" (payments for each rerun after the initial showing) to actors performing in television commercials. IDC (a defendant below) was organized to develop a system for the electronic monitoring of television commercials as a method of accurately recording the extent to which such commercials are broadcast. The monitoring business was an entirely new and highly speculative venture, but it had the potential to provide a unique and invaluable service to the advertising industry.

The first substantial investment in IDC was by respondent Beneficial, which purchased an IDC convertible debenture for $425,000 in January of 1969, on the condition that T&R be made a wholly-owned subsidiary of IDC. In July of that same year, Beneficial converted that note into common stock in anticipation of a public offering by IDC which, however, was never consummated. The remainder of the common stock of IDC is held by Ross and by a number of his friends and associates, including plaintiff Peter Wright, who acquired stock at Ross' instance. The common stockholders had contributed, on average, one dollar per share for the approximately 835,000

shares outstanding, while petitioner Heizer Corporation made a series of investments totaling approximately $9,000,000—$3 million in preferred stock purchases and $6 million in loans.

Plaintiffs charged that all the principal investments of Heizer Corporation in IDC were made in violation of Rule 10b-5. The District Court, in an opinion written before this Court rendered its decisions in *Ernst & Ernst* v. *Hochfelder*, 425 U. S. 185 (1976), and *Santa Fe Industries, Inc.* v. *Green*, 430 U. S. 462 (1977), found that the initial Heizer Corporation investments were untainted but that Heizer Corporation violated Rule 10b-5 in connection with two later transactions, the "fourth" and "fifth" ones, because it acted unfairly and committed breaches of fiduciary duty owed to IDC. (A63-A64)

The Court of Appeals, in an opinion written after *Hochfelder* and *Green*, held that the District Court's rationale for finding liability was erroneous but nonetheless affirmed the liability of Heizer Corporation on other grounds. (A15-A27) Injunctive relief was ordered, cancelling and radically altering selected parts of Heizer Corporation's rights under the fourth and fifth transactions, and restricting the manner in which future securities transactions between Heizer Corporation and IDC may be accomplished. (A27, A30-A33)

2. The Investments by Heizer Corporation

For the sake of clarity, the principal transfers of money from Heizer Corporation to IDC have been divided into five distinct transactions. There is a recurring pattern to the financings, confirmed by undisputed evidence. Ross, as chief executive officer of IDC, would seek the necessary financing for the development of the continuously troubled monitoring business; his efforts would prove unsuccessful; Ross would turn to Heizer Corporation for interim financing, which Heizer Corporation would provide; and Ross would again begin to look for more money. Each time Heizer Corporation was the reluctant investor of last resort, and gradually, through that pattern of events,

Heizer Corporation was brought steadily closer to control of IDC.

a. The "First Transaction"

The first transaction was consummated in November of 1969. Ross, for IDC, was seeking a $1,000,000 capital contribution from a private investor as a preliminary step necessary for funding the development of the monitoring operation, and in anticipation of a $5,000,000 public offering of securities. After negotiation, IDC and Heizer Corporation agreed to a standard venture capital investment—$1,000,000 for non-voting preferred stock accompanied by warrants to purchase common stock, at the price of $8.50 per share. Because of the wide disagreement between the parties over the real value of IDC common stock, the agreement included an "antidilution clause", which is described below, and a promise by IDC not to pledge the T&R stock or change the nature of its business. Heizer Corporation also agreed to loan IDC $500,000 for one year. Thus, in exchange for a substantial investment in a new and uncertain business, Heizer Corporation received a preferred stock position, a chance to participate as a common stockholder if the company proved successful, and a form of protection against the dilution of that opportunity. This transaction was approved by unanimous votes of the IDC board of directors and stockholders, and was held to be untainted. (A5-A6, A44-A45, A62-A63)

The "antidilution clause" was developed as a compromise to bridge the gulf between Ross and Heizer Corporation as to the proper exercise price for the warrants to purchase IDC common stock. Under this clause, it was provided that if IDC should later sell common stock or rights to acquire common stock at a price below $8.50 per share, the initial price set in the Heizer Corporation warrants would automatically be reduced to that level and the number of shares purchasable would be proportionately increased. (A6 n. 2) Such provisions are commonly used in investment agreements when there is no available market price for the stock. (Trial Tr. 982, 2252)

b. The "Second Transaction"

The public offering contemplated at the time of the first transaction did not take place. By September of 1970, IDC was again strapped for cash and Ross turned to Heizer Corporation. For $2,000,000 from Heizer Corporation, IDC converted Heizer Corporation's 100,000 shares of preferred stock from the first transaction into 100,000 shares of new voting preferred stock and issued an additional 200,000 shares of the new preferred stock with a stated value of $10 per share. Heizer Corporation also received additional warrants to purchase 400,000 shares of IDC common stock at an initial exercise price of $6 per share accompanied by an antidilution provision identical to that used in the first transaction.* Again, the transaction was unanimously approved by IDC's board of directors and stockholders and was found free of wrongdoing. (A6-A7, A45-A46, A62-A63)

c. The "Third Transaction"

From the beginning, the monitoring operation was faced with a number of technical and regulatory problems. Its continuing development costs more than offset T&R's profits, and Ross was constantly in search of large amounts of capital for IDC. Despite a number of leads, the alternative sources of financing never materialized.

In May of 1971, Ross once more approached Heizer Corporation as the investor of last resort. By unanimous votes, IDC's board of directors and stockholders again approved a transaction in which, this time, Heizer Corporation invested $1,700,000 ($500,000 of which was used to repay a Heizer Corporation loan due May 25, 1971) in return for a twenty-year senior note for that amount and warrants to purchase an additional 472,222 shares of common stock at $3.60 per share. Under the prior antidilution clauses, the exercise price of

* By agreement, however, the antidilution provision of the first transaction was not triggered by this transaction.

warrants issued in the first two transactions was reduced and the quantity was adjusted upward so that Heizer Corporation's warrants could then be exercised at $3.60 per share to purchase 1,304,000 common shares (or a total of 61% of the equity).

In order to provide for the possible exercise of the warrants and to give Heizer Corporation voting power equivalent to its *pro forma* equity position, IDC's Certificate of Incorporation was amended to increase the number of authorized common shares to 3 million and to provide that the preferred stock would receive 4.4 votes per share, thereby giving Heizer Corporation majority voting control (except where a class vote is required). This transaction, too, was found to be untainted. (A7-A8, A46-A48, A62-A63)

Up to this point, Heizer Corporation had neither sought nor accepted representation on IDC's board. As Edgar F. Heizer, Jr., president of Heizer Corporation, explained at trial, venture capitalists normally are not interested in having control over or participating in the management of their "investee" companies. While Heizer Corporation must occasionally provide advice and assistance to the management of such companies, it is only in the business of investing, and not of acquiring companies or operating them. (Trial Tr. 996) At the close of the third transaction, however, two Heizer Corporation nominees were elected to the seven-man board of directors of IDC. (A8)

The documentation for each of the early transactions, and the fourth transaction was worked on by Bernard Kury, Esq. of the New York law firm of Dewey, Ballantine, Bushby, Palmer and Wood (Heizer Corporation's counsel), by Michael Sigal, Esq. of the Chicago law firm of Sidley & Austin (IDC's counsel) and by IDC's in-house counsel. Edgar Heizer testified that he relied entirely upon the lawyers to handle the details for all transactions and to make certain that Heizer Corporation was in full compliance with the law. (Trial Tr. 552-53) In that regard, Ross specifically stated at trial that counsel for Heizer Corporation never suggested that any information be withheld from the common stockholders. (Trial Tr. 283-84, 311-12)

d. The "Fourth Transaction"

During the summer of 1971, Ross again sought outside funds, and Heizer Corporation tried to assist Ross whenever possible. (Trial Tr. 1920-21, 1956) The monitoring operation was still plagued with regulatory and technical problems, however, and IDC's financial situation was becoming desperate.

In the fall of 1971 McCormick and Company, an investment banking firm, decided that if IDC had a profitable first quarter in 1972, McCormick could conduct a successful speculative underwriting for IDC in April of 1972.* Interim financing was essential, however, and McCormick suggested that either Beneficial or Heizer Corporation provide additional funds. Beneficial refused and Heizer Corporation initially declined because its investment in IDC was already substantial. (Trial Tr. 1653-54)

McCormick, on behalf of IDC, then began looking for $1.5 million in interim financing but was unable to locate any outside money, in part because Ross had "soured" many potential investors in IDC with his unfulfilled projections. (Trial Tr. 1656) McCormick remained optimistic, however, and Heizer Corporation agreed to cooperate fully with McCormick in raising the interim funds through a private placement (including waiving the triggering of its antidilution rights). (Trial Tr. 1660-62, 1702) In the midst of McCormick's efforts, IDC ran out of money and began withholding payments to its trade creditors. Telephone companies began disconnecting the lines to IDC's monitors; and, according to expert testimony at trial, at this point IDC was "bankrupt," with no value at all unless someone put more money into it. (Trial Tr. 864, 2239, 2267-68)

Heizer Corporation advanced $60,000 to IDC and prepared a proposal to save IDC from bankruptcy proceedings, so that McCormick could continue its efforts to find outside financing for IDC. Heizer Corporation's proposal, which became

* McCormick had been told by an officer of IDC that the technical problems were over and that IDC projected that its operations would break even in early 1972. (Trial Tr. 1649)

the fourth transaction, was consummated on November 19, 1971, and involved the issuance by IDC of up to $600,000 in promissory notes due on March 31, 1972. The agreement provided that if the full amount had been lent and not repaid by that date, the loan would become convertible into common stock at $1 per share. At that point the antidilution clauses from the first three transactions would be triggered and Heizer Corporation would become entitled to purchase 4,694,000 shares of IDC common stock at $1 per share, or 85% of the company's equity. (A8-A9, A48-A49)

The resignation of two directors from the IDC board and the absence of Loew, the Beneficial representative,* left only four participating directors, two of whom were the Heizer Corporation nominees. By this point Heizer Corporation had already invested $4.7 million (or approximately five times the total investment of all the common stockholders). At the board meeting on November 19, 1971 at which the transaction was approved, the Heizer Corporation nominees insisted that the other two directors vote first, after telling them that Heizer Corporation would not make the investment unless both of them approved. Ross and LaBow, an outside director, voted in favor of the transaction; and the Heizer Corporation nominees then made it unanimous. (A9, A49)

As an incident to this transaction, the attorneys for IDC and Heizer Corporation prepared an amendment to the Certificate of Incorporation to increase the number of authorized shares of common stock from 3 million to 7 million. Stockholder approval was required for this amendment. Both counsel for IDC and Heizer Corporation decided that, because of IDC's urgent financial needs, there was not enough time to hold a stockholders' meeting and that the quickest available procedure was to obtain written consents from holders of a majority of the outstanding stock, as is permitted under Delaware law. Consent forms were

* Loew had been apprised of the terms of the fourth transaction but was out of the country on November 19, 1971.

prepared by counsel for Heizer Corporation (Kury) and by counsel for IDC (Sigal); and, at the request of Sigal and IDC's in-house counsel, Ross, chief executive officer, principal stockholder and founder of IDC, undertook to get the consents. (Trial Tr. 225-26)

The District Court held that Heizer Corporation violated Rule 10b-5 in connection with this transaction because the transaction was unfair and involved self-dealing by Heizer Corporation. (A63-A64) The Court of Appeals, after rejecting the District Court's theory in light of intervening decisions of this Court (A14), made its own findings that Heizer Corporation was guilty of non-disclosure and scienter, and, on the basis of those findings, ruled that Heizer Corporation violated Rule 10b-5 in connection with this transaction. (A15-A19, A22, A25-A26)

By March 13, 1972, IDC had borrowed the entire $600,000, and a second loan under the terms of the fourth transaction had been made for $250,000. McCormick's efforts to find financing had been halted earlier when still greater technical problems with IDC's monitoring operations were revealed. (Trial Tr. 1655) None of these loans was repaid by March 31, 1972 and Heizer Corporation then was in a position to acquire 87% of IDC's common stock at $1 per share. (A10, A50) Since IDC still remained essentially bankrupt, none of these warrants was ever exercised by Heizer Corporation.

e. The "Fifth Transaction"

Between March of 1972 and April of 1973, Heizer Corporation extended $2,015,000 in nonconvertible demand loans to IDC to keep the monitoring business afloat while solutions to its problems were being pursued. In April, 1973, Heizer Corporation agreed to defer repayment of all demand loans and to commit additional funds in exchange for a pledge of the T&R stock. Following the pledge IDC borrowed an additional $1.4 million from Heizer Corporation on the same terms. None of these loans was convertible into stock and no warrants were issued with them. (A11-A12, A51)

With respect to the fifth transaction, the District Court found that Heizer Corporation had engaged in self-dealing while occupying a fiduciary relationship to IDC and therefore declared the pledge of T&R stock void. (A64) The Court of Appeals again rejected the trial court's theory of decision but held that Heizer Corporation nevertheless violated Rule 10b-5 because the IDC common stockholders were not given the opportunity to vote on the transaction. (A19-A21)

REASONS FOR GRANTING THE WRIT

The Court of Appeals' decision in this action is in direct conflict with principles established in recent decisions of this Court and is in conflict with established, reasoned lines of precedent in other circuits. A number of the recent decisions of this Court interpreting the federal securities laws have been reversals of the Court of Appeals for the Seventh Circuit. *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U. S. 438 (1976), *rev'g* 512 F. 2d 324 (7th Cir. 1975); *Ernst & Ernst* v. *Hochfelder*, 425 U. S. 185 (1976), *rev'g* 503 F. 2d 1100 (7th Cir. 1974); *Rondeau* v. *Mosinee Paper Co.*, 422 U. S. 49 (1975), *rev'g* 500 F. 2d 1011 (7th Cir. 1974). *See also Blue Chip Stamps* v. *Manor Drug Stores*, 421 U. S. 723, 732, 748 (1975), disapproving *Eason* v. *General Motors Acceptance Corp.*, 490 F. 2d 654 (7th Cir. 1973), *cert. denied*, 416 U. S. 960 (1974).

In each of the cited cases, the Seventh Circuit had imposed an improperly light burden of proof on the plaintiff. The same is true of the instant case. Review of the decision below is particularly important because the Court of Appeals seriously misinterpreted this Court's most recent decisions under Rule 10b-5.

After the District Court rendered its principal decision herein on December 3, 1975, this Court decided several cases under Rule 10b-5 which control issues presented by the instant case. *Ernst & Ernst* v. *Hochfelder*, 425 U. S. 185 (1976), held that in order to sustain a private cause of action for damages under Rule 10b-5 there must be a showing of scienter, *i.e.*, an "intent to deceive, manipulate, or defraud." 425 U. S. at 193. After oral argument of the instant case before the Court of Appeals, this Court rendered its decision in *Santa Fe Industries, Inc.* v. *Green*, 430 U. S. 462 (1977), which held that in order to sustain a private cause of action under Rule 10b-5 there must be a showing of manipulation or deception, and that evi-

dence of a breach of fiduciary duty not involving deception or manipulation is insufficient. 430 U. S. at 473-480.* In the instant case, however, the District Court had found liability under Rule 10b-5 on a theory not involving deception or manipulation and without finding scienter on the part of petitioner Heizer Corporation. (A63-A64) Thus, the District Court functioned under a serious misapprehension of correct legal principles in numerous respects.

In its decision the Court of Appeals ostensibly relied heavily on the intervening rulings in *Hochfelder, Green* and *Northway*. (A14, A17, A21, A25) After noting the absence of relevant findings by the District Court on the issues of scienter and deception (A15 n. 9, A25) and the errors of that court's legal reasoning (A14), the Court of Appeals proceeded to conduct a *de novo* review of the trial record. The Court of Appeals then made its own findings of fact and came to its own conclusions as to the liability of Heizer Corporation.

Wholly apart from the decisional conflicts and errors of law discussed below, it is important to emphasize the manifest unfairness of this approach to petitioner. The finder of fact in a non-jury trial is the District Court, not the Court of Appeals. Fed. R. Civ. P. 52(a). In these circumstances, where there are disputed issues of fact which the trial court did not resolve and the whole framework of the litigation has been altered by several intervening decisions of a higher court, the proper course for an appellate tribunal is to remand the case for a thorough review by the finder of fact in the first instance, not to usurp that function by making findings of its own, especially when the District Court has decided the case on theories no longer

* In a third apposite decision rendered by this Court after the District Court ruling, *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U. S. 438 (1976), this Court held, in effect, that the test of whether a fact is "material" for purposes of a private cause of action under Rule 10b-5 is whether there is a "substantial likelihood" that disclosure of the fact in question "would have assumed actual significance in the deliberations of the reasonable shareholder." 426 U. S. at 449.

viable under Rule 10b-5.* *See generally* 5A *Moore's Federal Practice* ¶ 52.06[2] (2d ed. 1977). The appellate usurpation of that function in this case requires the exercise of this Court's supervisory powers under Supreme Court Rule 19.**

I.

THE IMPOSITION OF LIABILITY ON HEIZER CORPORATION WAS INCONSISTENT WITH THIS COURT'S DECISIONS IN ERNST & ERNST v. HOCHFELDER AND SANTA FE INDUSTRIES v. GREEN AND IS IN CONFLICT WITH DECISIONS OF OTHER COURTS OF APPEALS

A. Heizer Corporation Did Not Act with Scienter in the Fourth Transaction

The Court of Appeals not only arrogated to itself the right to make the finding of scienter required by *Ernst & Ernst* v. *Hochfelder*, 425 U. S. 185, 193 (1976), but in so doing applied an erroneous legal standard.

The Court of Appeals held that Heizer Corporation acted with scienter because—at a time when it was clearly not in control of the board of directors or the management of IDC—it should not have delegated certain responsibility, or permitted certain delegation of responsibility, in connection with obtaining the common stockholders' approval of IDC corporate action related to the fourth transaction.*** That is, in deferring to a

* This is not the only recent instance of appellate fact-finding by that court. In *Sundstrand Corp.* v. *Sun Chemical Corp.*, 553 F. 2d 1033, 1050 n. 35 (7th Cir. 1977), *cert. denied*, 46 U. S. L. W. 3207 (1977), the Court of Appeals expressly sanctioned appellate fact-finding in reliance on material outside the trial record.

** Rule 19.1(b) provides for the grant of certiorari where the lower court "has so far departed from the accepted and usual course of judicial proceedings . . . as to call for an exercise of this court's power of supervision."

*** The precise basis for the court's holding is not clear. It may have been based on vicarious liability for the supposed scienter of those to whom responsibility was delegated. That theory, as well, would be erroneous. *See Part* I.B, *infra*.

partner of the eminent law firm of Dewey, Ballantine, Bushby, Palmer and Wood (as well as to IDC's outside and inside counsel) to assure that all legal requirements were met and in permitting IDC's chief executive officer, Ross, to obtain common stockholder consents to an IDC charter amendment which was not essential to the financing, Heizer Corporation was held to have acted with *intent to defraud*.*

There is simply no basis for concluding that petitioner acted with scienter in relying upon Bernard Kury of Dewey Ballantine. There is no evidence which even suggests that Heizer Corporation suspected that Kury would fail in his responsibility in any respect.** Indeed, as the Court of Appeals noted, in the past Kury had required IDC to retrace some of its steps when Kury was not satisfied that legal requirements had been observed. (A18)

Petitioner does not suggest that reliance upon counsel in and of itself precludes a finding of scienter. Rather, where counsel has been relied upon in a matter requiring legal expertise, there can be no finding of scienter absent affirmative evidence of some knowledge on the part of the defendant that the attorney would probably act improperly. Hawes & Sherrard, "Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases," 62 *Va. L. Rev.* 1, 127 *et seq.* (1976) (analyz-

* The single act of stockholders in the fourth transaction was to consent to an amendment to the IDC Certificate of Incorporation increasing the number of common shares authorized from 3 million to 7 million. But this amendment was surplusage to the financing itself. As a matter of corporate law, the fourth transaction could have been consummated without the increase in the number of authorized common shares. The increase was undertaken merely because the number of common shares into which warrants and convertible securities held by Heizer Corporation might be converted at some future date would in the aggregate exceed the number of unissued authorized common shares. Indeed, if the amendment had not been presented or approved, Heizer Corporation could have converted enough shares at a later date to obtain a majority of the common stock and then voted for an amendment authorizing sufficient additional shares to fulfill IDC's contractual obligation to it.

** Petitioner does not concede and, in fact, denies that Kury acted improperly in any respect.

ing the defense in actions under Rule 10b-5 primarily in the context of liability for negligent conduct); Hawes, "Reliance on Advice of Counsel as a Defense," *PLI Eighth Annual Institute on Securities Regulation* 39, 41-43 (1977). *Cf. Coleco Industries, Inc.* v. *Berman*, 423 F. Supp. 275, 296 (E. D. Pa. 1976) (scienter consists of "conscious deception" or conduct so reckless as to be "virtually indistinguishable in its culpability from deliberate fraud"); *Hirsch* v. *du Pont*, 553 F. 2d 750, 759 (2d Cir. 1977) (to aid and abet another's actionable non-disclosure, the defendant must have "knowledge of the fraud, and not merely [of] the undisclosed material facts").

The Court of Appeals also held that Heizer Corporation acted with scienter in permitting IDC (whose board Heizer Corporation did not control at that time) to delegate to Ross the responsibility to obtain the consents, even though Heizer Corporation had no obligation to supervise that corporate act and IDC was represented by its own responsible outside and inside counsel. Here the Court of Appeals constructed its own chain of inferences upon inferences in order to find scienter where the District Court had made no finding at all. Ross had told IDC's outside counsel and Kury that because the stockholders were his friends, he (Ross) "would be able to get their signatures in the short period of time available." (A26) From that the Court of Appeals "implie[d] that consents would be solicited on the basis of friendship" rather than full disclosure. (A26) Moreover, the stockholders' tendency to trust the judgment of Ross "*would be* further enhanced by the fact that Ross, who was the single largest shareholder, *would seem* to be the most vitally concerned with the corporation's welfare." (A26) (Emphasis added.) The emphasized phrases indicate the extent to which the Court of Appeals was dealing in the speculative where the District Court did not make any findings at all on the ultimate issue of scienter. The fact that in other contexts Heizer Corporation believed that Ross had a tendency to be "unrealistic about IDC and its prospects" (A26) hardly supports

a finding that in this particular instance Heizer Corporation was guilty of scienter in standing silent while IDC's chief executive officer and largest stockholder, Ross, undertook to obtain the stockholder consents.

In fact, rather than suspecting that Ross would not make adequate disclosure, Heizer Corporation knew that holders of a majority of the stock were fully informed. Not counting Beneficial (which opposed the fourth transaction), more than 50% of the common stock was held by persons who were fully advised of the terms of the proposed transaction, had expressed no opposition to it, and who therefore did not need any additional disclosure.* However, in getting the signatures necessary to make a majority from others than himself, Ross did not contact only those who were fully informed. Rather—without any knowledge or participation of Heizer Corporation—he bypassed some who knew all about the transaction and gathered a few consents from smaller stockholders who had *not* participated in the negotiations.** Heizer Corporation reasonably believed that any required disclosure had been made, a fact confirmed in the legal opinion issued by IDC's own law firm.***

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* Ross controlled 42%; DeKraker and Johnston, both IDC board members, owned 7% in the aggregate; LaBow owned 2%; Sigal's law firm owned 1%. (Plaintiff's Exhibit 66) DeKraker and Johnston attended the November 12, 1971 board meeting at which the fourth transaction was negotiated. (Trial Tr. 1967)

** Ross, LaBow and Sigal's law firm (the only consent Ross did not secure personally) all had full disclosure and signed consents. They represented 45% of the common stock. The other eight common stockholders who signed consents (holding 7%) were friends or business associates of Ross.

*** The opinion of IDC's outside counsel stated, in part, as follows:

> The execution, delivery and performance of the Agreement by IDC, and the amendment of its Certificate of Incorporation as set forth in the aforesaid Certificate of Amendment, have been duly authorized by all requisite action of IDC's Board of Directors and stockholders. (Plaintiffs' Exhibit 76)

In nevertheless finding Heizer Corporation liable, the Court of Appeals' decision conflicts with *Hirsch* v. *du Pont*, 553 F. 2d 750, 759 (2d Cir. 1977) (no scienter where defendant reasonably believes all the facts have been disclosed); *see also Nelson* v. *Hench*, 428 F. Supp. 411, 416 (D. Minn. 1977) (failure to make disclosure when defendant did not know that such failure aided another's unlawful scheme is not scienter).

These facts, and the Court of Appeals' heavy reliance upon what "would" seem to be the case and upon what might be "implied" from the record, demonstrate that that court in fact merely held that Heizer Corporation "should have known" that Ross and Kury would not faithfully discharge their respective responsibilities. Courts have ruled uniformly, after *Hochfelder*, that an allegation or finding that a defendant "should have known" of certain facts does not constitute the necessary allegation or finding of scienter. ***E.g. First Virginia Bankshares*** v. *Benson*, 559 F. 2d 1307, 1318-19 (5th Cir. 1977); *Miller* v. *Schweickart*, 413 F. Supp. 1062, 1065 n. 8 (S. D. N. Y. 1976); *Peltz* v. *Northern Ohio Bank*, 430 F. Supp. 382, 384 (N. D. Ohio 1976). In effectively holding to the contrary, the Court of Appeals for the Seventh Circuit has placed itself in conflict with every other court which has considered this question.

Hochfelder had left open the question whether reckless conduct, when equivalent to intentional conduct, constitutes scienter as required by Section 10(b). 425 U. S. at 193 n. 12. Even if recklessness which is equated with intentional conduct constitutes scienter for purposes of Rule 10b-5, no such conduct was present here. The holding below that petitioner acted recklessly in violation of Rule 10b-5 (A25) so dilutes the nature of recklessness as to render it indistinguishable from gross negligence or ordinary negligence, thereby obliterating the very distinction which this Court sought to establish in *Hochfelder*, 425 U. S. at 210, 214.

In sum, in the fourth transaction the petitioner, a venture capital firm, sought to provide further financial aid to a failing

entity with a handful of stockholders, principally friends of the founder. In the course of that transaction, petitioner voluntarily participated to a limited degree, through counsel, in submitting a single issue for the consent of stockholders—consent which was not essential to the financing. The attorney on whom petitioner principally relied had acted with demonstrated care in the past. The predominant proportion of the necessary stockholder consents came directly from the principal stockholder and founder of IDC, who obtained the other consents as well. (A17) Petitioner manifestly did not act with "intent to deceive, manipulate, or defraud." If it did, then *Hochfelder*, a reversal of another decision of the Court of Appeals below, has brought no change in the law.

B. Any Holding That Heizer Corporation Was Vicariously Liable Under Rule 10b-5 Is in Conflict with Decisions of Other Courts of Appeals

If, in finding Heizer Corporation liable under Rule 10b-5 in connection with the fourth transaction, the Court of Appeals was not holding Heizer Corporation primarily liable but rather only secondarily liable for the failures of others—i.e., Dewey Ballantine or Ross—then the Court of Appeals erred in failing to apply the standards of Section 20(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78t(a).

Whenever vicarious liability is to be imposed for a violation of the federal securities laws, such liability must be founded, if at all, on the secondary liability provisions of the securities laws, Section 15 of the 1933 Act, 15 U. S. C. § 77o, and Section 20(a) of the 1934 Act, the so-called "controlling person" sections. That is the clear import of this Court's recent decisions holding that implied rights of action under the federal securities laws are circumscribed by the parameters of express causes of action under those laws, including statutory defenses. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U. S. 723, 736 (1975);

Ernst & Ernst v. *Hochfelder*, 425 U. S. 185, 208-210 (1976). If the Court of Appeals' opinion should be read as imposing vicarious liability on Heizer Corporation, the decision contravenes the foregoing requirement.

As distinguished from the common law doctrine of *respondeat superior*, where the principal's liability is absolute (*Holladay* v. *Kennard*, 79 U. S. 254 (1870)), liability of controlling persons under the securities laws is expressly subject to a specific affirmative defense. The affirmative defense under Section 20(a) of the 1934 Act is that the defendant "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." (The facts demonstrating that Heizer Corporation could have sustained that defense as to the fourth transaction, had the courts below considered it, are discussed above at pages 10-11, 16-18.)

The following Courts of Appeals have held that the controlling person sections are the exclusive means of establishing vicarious liability in actions under Rule 10b-5 and various other provisions of the federal securities laws: *Zweig* v. *Hearst Corp.*, 521 F. 2d 1129, 1132-33 (9th Cir. 1975), *cert. denied*, 423 U. S. 1025 (1975); *Lanza* v. *Drexel & Co.*, 479 F. 2d 1277, 1299 (2d Cir. 1973); *Rochez Bros., Inc.* v. *Rhoades*, 527 F. 2d 880, 884-86 (3d Cir. 1975); *Myzel* v. *Fields*, 386 F. 2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U. S. 951 (1968). The following Court of Appeals have held that vicarious liability may be predicated upon common law concepts even if the liability of the primary wrongdoer was founded solely under the federal securities laws: *Holloway* v. *Howerdd*, 536 F. 2d 690, 695 (6th Cir. 1975); *Johns Hopkins University* v. *Hutton*, 422 F. 2d 1124, 1130 (4th Cir. 1970), *cert. denied*, 416 U. S. 916 (1974); *Fey* v. *Walston & Co., Inc.*, 493 F. 2d 1036, 1052 (7th Cir. 1974). This conflict between the circuits should be resolved so that the applicable principles of vicarious and secondary liability under the federal securites laws may be settled.

C. The Court of Appeals' Findings of Scienter, Material Non-Disclosure and Causation in the Fifth Transaction Were Improperly Based on Considerations of a Supposed Fiduciary Duty and Fairness.

In an action under Rule 10b-5 a plaintiff must prove not only scienter but also deception and causation. In finding liability under Rule 10b-5 in connection with the fifth transaction,* the Court of Appeals effectively ignored recent decisions by this Court concerning each of these elements.**

1. Scienter

In the fifth transaction IDC pledged to Heizer Corporation the stock of T&R, IDC's wholly-owned subsidiary, to secure additional short-term loans and to obtain a delay in payment of outstanding demand loans. In finding scienter there, the Court of Appeals held merely that Heizer Corporation participated in a decision not to submit the transaction to the stockholders of IDC for approval, approval which was not required by the Delaware General Corporation Law. (A19) The Court of Appeals held that in so doing Heizer Corporation was "blinded by a conflict of interest" and "wantonly ignored evidence of the

* Although the issue was not presented below, it should be noted that since the only purchase or sale even arguably involved in the fifth transaction was that of several short-term notes with no equity feature, no purchase or sale of a "security" was involved at all. Section 3(a)(10) of the 1934 Act, 15 U. S. C. § 78c(a)(10); *Great Western Bank & Trust* v. *Kotz*, 532 F. 2d 1252 (9th Cir. 1976); *McClure* v. *First National Bank of Lubbock, Texas*, 497 F. 2d 490, 492-95 (5th Cir. 1974), *cert. denied*, 420 U. S. 930 (1975). A pledge of securities in these circumstances is not a "sale." *McClure*, *supra*, 497 F. 2d at 495.

** Although the Court of Appeals' ruling discussed herein was ostensibly an alternative basis for the relief granted to the plaintiffs (A27-A28), that fact should not preclude review by this Court where an important question of federal law is presented, especially since petitioner seeks review of the fourth transaction, the illegality of which was the predicate for the alternative basis for relief as to the fifth transaction. (A27-A28)

unfairness of the securities transaction," citing the Seventh Circuit's own decision in *Bailey* v. *Meister Brau, Inc.*, 535 F. 2d 982, 993 (7th Cir. 1976).* (A27) The quoted test is not one of intent to deceive, but rather bespeaks a breach of fiduciary duty, which is not scienter. *Cole* v. *Schenley Industries, Inc.*, CCH Fed. Sec. L. Rep. ¶ 96,166, at p. 92,288 (2d Cir. 1977) [Current Binder].

2. Deception

Santa Fe Industries, Inc. v. *Green*, 430 U. S. 462 (1977), made clear that it is not the purpose of the federal securities laws, and in particular, Rule 10b-5, to vindicate every common law breach of fiduciary duty which may touch a securities transaction. 430 U. S. at 471-80. *See also Piper* v. *Chris-Craft Industries, Inc.*, 430 U. S. 1, 40-41 (1977). Nevertheless, in holding the fifth transaction unlawful the Court of Appeals relied on nothing more than an arguable breach of fiduciary duty as the basis for finding the elements of deception and causation to be present.

The Court of Appeals acknowledged that the Delaware General Corporation Law did not require stockholder approval of the pledge of the T&R stock. (A19) There was full disclosure to the IDC board of directors, and, the court reasoned, disclosure of relevant facts to the IDC board was sufficient under Rule 10b-5 unless Heizer Corporation controlled the board "to such an extent that only the independent shareholders were able to safeguard the corporation's interests." (A19) The court concluded that since a majority of the directors of IDC was con-

* *Bailey* cannot stand as a well-considered post-*Hochfelder* analysis of Rule 10b-5. *Bailey* was briefed and argued more than a year before *Hochfelder* was decided by this Court. *Bailey* was decided just a few weeks after *Hochfelder*. The sole reference in *Bailey* to *Hochfelder* is a mere statement that nothing in *Bailey* is contrary to *Hochfelder* (535 F. 2d at 994 n. 14), yet at 535 F. 2d at 993 *Bailey* expressly relied on *Sanders* v. *John Nuveen & Co., Inc.*, 524 F. 2d 1064, 1069 (7th Cir. 1975), which had been vacated by this Court for reconsideration in light of *Hochfelder* prior to the *Bailey* decision. 425 U. S. 929 (1976).

trolled by Heizer Corporation and Heizer Corporation had an alleged "conflict of interest, it had the obligation to disclose to the other stockholders information in its possession which reflected on the fairness of the transaction." (A20, quoting *Bailey* v. *Meister Brau, Inc.*, 535 F. 2d 982, 993 (7th Cir. 1976), discussed *supra*, p. 23 n.*) Accordingly, Heizer Corporation was held obligated under Rule 10b-5 to disclose the material facts regarding the pledge to the other stockholders.

In so holding, the Court of Appeals was evidently paying lip service to *Green*, which held that manipulation* or deception is necessary to sustain a cause of action under Rule 10b-5, and that unfairness or breach of fiduciary duty alone is not enough. 430 U. S. at 473-78. Yet the Court of Appeals conceded that there was reasonably prompt disclosure of the transaction to the stockholders *after* it was approved. (A20-A21) Advance disclosure to stockholders was not necessary to permit the stockholders to vindicate their rights under state law, since no irrevocable steps had been taken prior to disclosure of the transaction to the stockholders. To paraphrase *Green* (430 U. S. at 474 n. 14) (where there also was disclosure after the fact, 430 U. S. at 474), plaintiffs cannot point to any state law remedy such that "they might have acted differently"—and with greater effect—"had they had prior notice of" the pledge.

The real gravamen, then, was not non-disclosure but the domination of the IDC board of directors by Heizer Corporation and the alleged conflict of interest. "[T]he essence of the complaint is that shareholders were treated unfairly by a fiduciary." *Green*, 430 U. S. at 477. Such issues are "traditionally relegated to state law." *Green*, 430 U. S. at 478, quoting *Piper* v. *Chris-Craft Industries, Inc.*, 430 U. S. 1, 40 (1977), in turn quoting *Cort* v. *Ash*, 422 U. S. 66, 78 (1975).

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* On any theory there was no "manipulation" here, since that "refers generally to practices . . . that are intended to mislead investors by artificially affecting market activity." *Green*, 430 U. S. at 476.

See Section 144 of the Delaware General Corporation Law; *Kaplan* v. *Centex Corporation*, 284 A. 2d 119 (Del. Ch. Ct. 1971). Rule 10b-5 is not a charter for federal courts to frame federal standards of corporate conduct or fiduciary duty. *Green*, 430 U. S. at 479-80. If the reasoning of the Court of Appeals herein were followed, however, every act of a board of directors involving a breach of fiduciary duty and incidentally involving a securities transaction would, *ipso facto*, entail a deceptive non-disclosure to stockholders and thus become a matter of federal concern—in direct contravention of the spirit if not the letter of *Green*. *See Goldberg* v. *Meridor*, CCH Fed. Sec. L. Rep. ¶ 96,162, at p. 92,271 (2d Cir. 1977) [Current Binder] (Meskill, J., concurring in part and dissenting in part).

3. Causation

The Court of Appeals' holding that plaintiffs had also established causation (A22-A24) was similarly predicated on the erroneous conclusion that the failure to make disclosure in advance deprived the stockholders of a viable common law right to assert that the fifth transaction was unfair. But the stockholders had ample opportunity after the transaction was disclosed to assert their common law rights.

In using a conflict of interest analysis to manufacture the necessary finding of deception and using an analysis of the fairness of the transaction to establish causation, the Court of Appeals inextricably intertwined the concepts of fiduciary duty and state corporate common law with the federal securities laws in a manner which directly contravenes this Court's admonition to leave state law concerns to the proper forum. The expansion of Rule 10b-5 here to "corporate conduct traditionally left to state regulation" (430 U. S. at 478) is especially egregious in light of the fact that IDC is a closely held corporation whose stock was never sold to the public, while the Securities Exchange Act of 1934 is "chiefly concerned with the regulation of post-distribution trading on the Nation's stock exchanges and securi-

ties trading markets." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U. S. 723, 752 (1975). This petition should be granted so that the separation between the proper concerns of federal law and of state law can be clarified and preserved.

II.

THE RELIEF ORDERED BY THE COURT OF APPEALS EXCEEDED THAT COURT'S AUTHORITY UNDER THE SECURITIES EXCHANGE ACT, IS IN CONFLICT WITH DECISIONS OF THIS COURT AND WOULD ESTABLISH A DANGEROUS PRECEDENT WITH NO LIMITS ON A COURT'S DISCRETION

A. The Primary Relief

The relief which the Court of Appeals ordered in connection with the fourth transaction changed the convertible notes to nonconvertible notes. That court also ordered that demand loans made after the third transaction should be changed to provide a set maturity date "commensurate with IDC's ability to pay", to be determined at a further hearing by the District Court, and nullified the pledge of T&R stock. (A27-A31) In going beyond compensatory damages and rescission, that relief, misleadingly characterized as "unraveling past transactions" (A27), is totally unwarranted under the 1934 Act.*

It is settled that an award of damages is an appropriate remedy for violation of Rule 10b-5. *Affiliated Ute Citizens* v. *United States*, 406 U. S. 128, 155 (1972). Rescission is another available remedy, subject to traditional equitable defenses. In particular, Section 29(b) of the 1934 Act, 15 U. S. C. § 78cc(b), provides in pertinent part as follows:

* The Court of Appeals' statements that Heizer Corporation "agrees" to the appropriateness of certain relief (A27) are in error. Petitioner never stated any such concession at any stage of these proceedings. Moreover, certain of the relief challenged in this petition was first imposed by the Court of Appeals.

> Every contract made in violation of any provision of this title or of any rule or regulation thereunder . . . shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract . . . .

As interpreted by this Court in *Mills* v. *Electric Auto-Lite Co.*, 396 U. S. 375, 387 (1970), Section 29(b) means that an innocent party to a transaction induced by a violation of, *e.g.*, Rule 10b-5, has a right to void the transaction. To the same effect, *see Blue Chip Stamps* v. *Manor Drug Stores*, 421 U. S. 723, 735 (1975). Void, of course, means to nullify in its entirety, not to undo or revise selected portions of the transaction. *E.g.*, *Sparks* v. *United States*, 153 F. Supp. 909 (D. Vt. 1957).

Other provisions of the federal securities laws which expressly establish private rights of action specify remedies of damages or rescission, but none permits dissection of a transaction so as to saddle the defendant with only part of what he had bargained for or leave him with an entirely different investment. Section 12(2) of the Securities Act of 1933 ("1933 Act"), 15 U. S. C. § 77*l*(2), which provides a buyer with an express cause of action for misrepresentation in certain circumstances, provides the remedies of damages or rescission. Sections 9 and 18 of the 1934 Act, 15 U. S. C. § 78i and § 78r, which provide express causes of action for purchasers and sellers in certain circumstances, provide a damage remedy. Section 28(a) of the 1934 Act, 15 U. S. C. § 78bb(a), limits recovery to "actual damages." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U. S. 723, 734 (1975). As noted, Section 29(b) explicitly provides for rescission.

This Court held in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U. S. 723, 736 (1975):

> It would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially im-

> plied cause of action beyond the bounds it delineated for comparable express causes of action. (Footnote omitted.)

See also Ernst & Ernst v. *Hochfelder*, 425 U. S. 185, 208-211 (1976). Similarly, when the express civil liability provisions have such narrowly circumscribed, but nevertheless sufficient, remedies it would be at least anomalous, if not patently outside the intent of the federal securities laws, to permit such a drastic remedy as wholesale restructuring of transactions under an implied right of action.*

Nevertheless, in the instant case the Court of Appeals, as well as the District Court, did not void or even "unravel" the transactions but modified them in such a way as to make their terms not at all what had been bargained for, to the great prejudice of petitioner Heizer Corporation. Thus, after petitioner parted with its cash, it was left with all of the risks—indeed more of the risks—but none of the potential benefits of the transactions at issue.**

The relief imposed on Heizer Corporation was clearly punitive, yet punitive damages are not recoverable under the federal securities laws. *deHaas* v. *Empire Petroleum Co.*, 435 F. 2d 1223, 1229-32 (10th Cir. 1970); *Globus* v. *Law Research Service, Inc.*, 418 F. 2d 1276 (2d Cir. 1969), *cert. denied*, 397

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* The issue presented by this petition does not pertain to equitable relief *pendente lite* (*Deckert* v. *Independence Shares Corp.*, 311 U. S. 282 (1940)) or ancillary relief necessary to implement an award of damages or rescission (*e.g.*, an accounting).

** There are several anomalies arising from this extreme remedy. First, the primary beneficiary of any reduction in Heizer Corporation's equity or right to equity in IDC is Ross, the principal common stockholder. Yet it was Ross' failure to disclose certain material facts which gave rise to Heizer Corporation's liability under the Court of Appeals' theory. (A16-A17, A26) Second, IDC, the real party in interest, was a fully active and voluntary participant—Heizer Corporation did not control the board of IDC at the time of the fourth transaction. (A18) The equitable doctrine of *in pari delicto* should bar IDC and Ross from obtaining any relief, directly or indirectly, as a result of their own wrongs. *Tarasi* v. *Pittsburgh National Bank*, 555 F. 2d 1152 (3d Cir. 1977), *cert. denied*, 46 U. S. L. W. 3355 (1977), and cases cited at 555 F. 2d at 1159-60.

U. S. 913 (1970). In light of the absence of statutory authority for the confiscatory action of the Court of Appeals, petitioner has been deprived of its property without due process. U. S. Const. Amendment V.

The precedent established by the Court of Appeals here is a pernicious one. For example, it would sanction a ruling that an unlawfully induced loan be converted into equity or that an investment in common stock be converted into debt, quite possibly on terms very unfavorable to the investor. A federal court has similar broad discretion to restructure property rights in proceedings under the bankruptcy laws, but such laws are authorized by a specific independent Constitutional power. U. S. Const. Art. 1, § 8, cl. 4. Here there is not even a statutory basis for the far-reaching relief which has been ordered.

Venture capital firms such as petitioner supply the lifeblood for risky enterprises with apparent potential, such as IDC. Sufficient financing in the early stages of development may not be available elsewhere, as was the case with IDC. To expose venture capital firms (or any investor or lender) to the risk of the unfettered discretion of a court operating years after the fact will only deter such investment, which is vital to the growth of our economy and the enterprise of the citizenry. In *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U. S. 723, 759-60 (1975), this Court stated in a similar context:

> If such a far-reaching change is to be made, with unpredictable consequences for the process of raising capital so necessary to our economic well-being, it is a matter for the Congress, not the courts.

Petitioner does not contest the proposition that remedies should be imposed upon those who violate the federal securities laws, but it strongly opposes the holding below to the effect that a court has carte blanche in fashioning any remedy it may choose beyond awarding actual damages or voiding the transaction, as provided in Section 29(b) of the 1934 Act. There is no authority for a court completely to rewrite the terms of a transaction involving the purchase or sale of securities.

B. Prospective Relief

The Court of Appeals' imposition of prospective relief was also in contravention of principles established by this Court. In *Rondeau* v. *Mosinee Paper Co.*, 422 U. S. 49 (1975), this Court held that in order to impose prospective injunctive relief on one who has violated the federal securities laws, the plaintiff must establish the traditional requisites of such equitable relief, including a showing of irreparable harm and the inadequacy of a remedy at law. 422 U. S. at 60-65. Neither necessary finding was made by the District Court or the Court of Appeals in this case. Accordingly, all of the prospective relief imposed by the Court of Appeals, as well as that originally imposed by the District Court, should be vacated.

Moreover, in light of the pervasive retrospective relief granted by the Court of Appeals (which, however, Heizer Corporation challenges), there could be no showing of irreparable harm or inadequacy of a remedy at law requiring the prospective relief imposed here. Indeed, if the fourth and fifth transactions were voided (rather than restructured in contravention of applicable principles of the 1934 Act (*supra*, pp. 26-29)), there could be no basis at all under *Rondeau* for the prospective relief which was ordered by the Court of Appeals.

CONCLUSION

For the reasons given, petitioner Heizer Corporation prays that a writ of certiorari issue to review the judgment and opinion below.

Respectfully submitted,

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December 7, 1977.

APPENDIX

Section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 20(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78t(a)

(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

* * * * *

Section 29(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78cc(b)

(b) Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation

thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation: *Provided*, (A) that no contract shall be void by reason of this subsection because of any violation of any rule or regulation prescribed pursuant to paragraph (2) or (3) of subsection (c) of section 15 of this title, and (B) that no contract shall be deemed to be void by reason of this subsection in any action maintained in reliance upon this subsection, by any person to or for whom any broker or dealer sells, or from or for whom any broker or dealer purchases, a security in violation of any rule or regulation prescribed pursuant to paragraph (1) of subsection (c) of section 15 of this title, unless such action is brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation.

* * * * *

SEC Rule 10b-5, 17 C. F. R. § 240.10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

OPINION OF THE COURT OF APPEALS
SEPTEMBER 9, 1977

IN THE UNITED STATES COURT OF APPEALS
For the Seventh Circuit

Nos. 76-1140, 76-1700, 76-1701 and 76-1702

PETER WRIGHT and BENEFICIAL STANDARD CORPORATION,
Plaintiffs-Appellants, Cross-Appellees,*

v.

THE HEIZER CORPORATION,
Defendant-Appellee, Cross-Appellant,

and

INTERNATIONAL DIGISONICS CORPORATION,
Defendant-Appellee.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 72-C-2536—Prentice H. Marshall, *Judge*.

Argued December 10, 1976—Decided June 30, 1977
Opinion Modified September 9, 1977

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* Plaintiffs in the derivative action (see the first paragraph of the text) filed the first notice of appeal (No. 76-1139) but later dismissed that appeal voluntarily. Thus, Heizer Corporation, although its role is essentially that of an appellant, is labelled the appellee and cross-appellant and plaintiffs are labelled the appellants and cross-appellees in the appeals filed in that action, which are Nos. 76-1140, 76-1700, and 76-1702. In No. 76-1701, an appeal from a separate action by Beneficial Standard Corporation against International Digisonics Corporation (see the first paragraph of the text), Beneficial is the appellant and IDC is the appellee.

Before CASTLE, *Senior Circuit Judge*, and TONE and WOOD, *Circuit Judges*.

TONE, *Circuit Judge*. These consolidated appeals arising out of a single case present issues under § 10(b) of The Securities Exchange Act of 1934, 15 U. S. C. § 78j, and Rule 10b-5 thereunder. Both plaintiffs join in a shareholders' derivative claim, asserting that the dominant shareholder defrauded the corporation in a series of five securities transactions. In addition, one of the plaintiffs asserts a claim against the corporation itself, alleging that false representations by one of the corporation's officers induced that plaintiff to convert a debenture into common stock.

I.

The Derivative Claim

A. *Facts*

International Digisonics Corporation (IDC) was formed in 1969 to develop electronic monitoring of television commercials as a service for the advertising industry. IDC's founder was Jordon Ross, who since 1962 had been successfully operating a company called Talent & Residuals Inc. (T&R), which provided advertising agencies with the complex accounting and payroll services required by the "residuals" paid to actors performing in television commercials.

The first investor in IDC, plaintiff Beneficial Standard Corporation, purchased a $425,000 convertible IDC debenture on the condition that the well-established and profitable T&R be made a subsidiary of IDC. In anticipation of a planned public offering of its stock, IDC requested that Beneficial convert its debenture to IDC common stock, at a $2.50 per share exchange ratio. This conversion is the subject of the individual action, discussed in Part II, *infra*. After the conversion, Ross and Beneficial owned approximately two-thirds of the corporation's stock; the remaining third was held by Ross friends and business associates.

As originally conceived, electronic monitoring involved encoding film or videotape commercials with electronic impulses which, while invisible to the viewer, could be read by electronic monitors. Placed in all major television markets, these monitors would report to a central computer, which would then use the data to generate a proof-of-performance report. This report would replace the affidavits from television stations that the advertising agencies were relying upon as proof that their commercials had been properly broadcast at the agreed-upon time.[1]

In the fall of 1969 IDC was seeking a $1,000,000 capital contribution from a private investor as a preliminary step to taking the company public. One investor it approached was defendant Heizer Corporation, which specializes in venture capital investments in newly-formed companies considered too risky for Heizer's stockholders—banks, pension funds, and universities—to invest in directly. Heizer was told that, provided FCC approval could be obtained, its $1,000,000 investment would enable the monitoring business to reach the break-even point necessary for a successful public offering. They were also told that, given a $5,000,000 capital investment from that public offering, a $5,500,000 profit could be anticipated from the monitoring business by 1971. [Pl. Ex. 62, Heizer Pre-Investment Summary & Analysis.] These "exceptional" prospects, coupled with the protection afforded by T&R's consistently good perform-

1. It was hoped that eventually the monitoring system could be used to perform more sophisticated functions such as market research and could also serve as an automated data-gathering system for a fully computerized T&R payroll system and a billing system between advertising agencies and television stations. [Jordon Ross, Tr. 207; Pl. Ex. 66, Heizer Corp. Business Appraisal Report, Aug. 1970. Occasional citations to the record and briefs of the parties are included in brackets in this slip opinion for the convenience of counsel and other representatives of the parties in their study of the opinion. Since the materials cited will ordinarily not be available to others, these bracketed citations will serve no further purpose when the opinion is published in the Federal 2d reports, and they, as well as this bracketed explanation, will therefore be deleted before the opinion is submitted to the publisher.]

ance, convinced Heizer that IDC was a desirable investment opportunity. [*Id.*]

Heizer offered to purchase IDC preferred stock, accompanied by warrants to purchase common stock, for $1,000,000; it also agreed to loan IDC $500,000 for one year. Following unanimous approval of this first transaction by the board of directors and stockholders of IDC on November 9, 1969, Heizer was issued 100,000 shares of a newly-created class A common stock (in reality a preferred stock) at $10 per share and warrants to purchase 155,000 shares of common stock at $8.50 per share. Although the preferred stock was not made expressly convertible, it was redeemable at Heizer's option and could be used at par in lieu of cash in exercising the warrants. During negotiations, the proper exercise price of the warrants was hotly disputed, with Jordon Ross, who negotiated for IDC, insisting on at least $10 per share and Heizer offering only $5 per share. The dispute was settled by compromising on the price and adding to the warrants an "antidilution clause"—or, as a Heizer vice-president called it, a price-adjustment clause—which would automatically readjust the price downward and the number of shares purchasable upward if IDC sold stock or rights to stock at a price lower than $8.50 per share.[2] The agreement also contained a number of other provisions designed to protect the Heizer investment, including IDC's agreement not to pledge its T&R stock or to change the nature of its business without Heizer's consent.

The contemplated public offering did not take place, however. Over the next eleven months IDC encountered a number of technical problems with monitoring, as well as administrative delay. At last, in April 1970, the FCC ruled favorably on the company's request for rulemaking, and in June 1970, IDC began actively marketing its services. [DeKraker monthly memos to

2. The formula for determining the new number of shares purchasable is: $\frac{\text{old exercise price} \times \text{old number of warrants}}{\text{new exercise price}}$

IDC board. Def. Ex. 1(b)-1(i).] Although a public offering was still contemplated [Def. Ex. 24], IDC was by this time also investigating other financing alternatives.[3] Needing additional operating capital immediately, IDC turned once again to Heizer. In September 1970 the second transaction, a $2,000,000 investment in two takedowns of $1,000,000 each, was arranged on the same general basis as before and was unanimously approved by IDC's board and shareholders. Heizer was to receive 200,000 shares of a new preferred stock at $100 per share,[4] with warrants to purchase 400,000 shares of common stock at an initial exercise price of $6 per share. If IDC had not met certain conditions not relevant here at the time of the second takedown, the price of the warrants would drop to $4 per share.[5] These warrants had an antidilution clause identical to that used in the first transaction; however, Heizer waived the antidilution provision in its first set of warrants so that their exercise price remained at $8.50 per share. [C. Palmer, Tr. 1903.]

In the next six months IDC was faced with more technical problems: film commercials often could not be monitored because of improper coding by film processors or improper alignment in broadcasting, and the apparent solution to these problems could not be implemented without a new ruling from the FCC. However, in his reports to IDC's board, the president of

3. There is disagreement over why none of these efforts ever produced concrete results: Heizer officers testified that Jordon Ross always insisted on unrealistic prices for the stock [E. Heizer, Tr. 994; C. Palmer, Tr. 1889], while an IDC director testified that rapidly deteriorating market conditions, the restrictive provisions in the first Heizer financing, and IDC's own operational difficulties made it impossible to acquire financing on a reasonable basis. [R. LaBow dep. 61-62.]

4. The Class A common stock created in the first transaction was also exchanged for the new preferred stock in this transaction.

5. In February 1971 Heizer, while proceeding with the second takedown, notified IDC that it was in default and that the warrant exercise price had therefore dropped to $4 per share. [Pl. Ex. 65.] IDC responded, denying default. [Def. Ex. 35.] The matter was never resolved.

the company, Glenn DeKraker, stated that monitors had been placed in all twenty-five top markets and that, while the system was turning out to be more complex than originally thought, it was being successfully debugged. [Def. Ex. 1(j)-1(n).]

In May of 1971, after several possible alternative sources of financing had fallen through, IDC again found it necessary to turn to Heizer for a third financing. IDC's board and stockholders again unanimously approved a transaction in which Heizer invested $1,700,000 ($500,000 of which was used to repay the Heizer loan due May 25th) in return for a twenty-year note in that amount and warrants to purchase an additional 472,222 shares of common stock at $3.60 per share. The prior antidilution clauses were partially triggered and, as a result, Heizer became entitled to 1,304,000 shares at $3.60 per share,[6] or a total of 61 per cent of the company's equity. In order to equate Heizer's voting power with this *pro forma* equity position, IDC's charter was amended to provide that the preferred stock would receive 4.4 votes per share. [E. Heizer, Tr. 660.] Two Heizer officers, Edgar Heizer and Charles Palmer, also became members of the IDC board at this time.

Over the next six months, IDC continued to experience technical difficulties with film encoding while pursuing a constant search for financing from sources other than Heizer. [Def. Ex. 1(o)-1(u).] The most promising source in the summer and fall of 1971 was the underwriting firm of McCormick & Co. Impressed by IDC's profit projections and by Heizer's substantial commitment to the company [Tr. 1687], McCormick issued a letter of intent in October 1971 looking toward a public offering.

6. This figure is 200,000 shares less than Heizer might have insisted upon receiving. At $3.60 per share Heizer was entitled to 365,972 shares under the warrants issued in the first transaction; a Heizer vice-president testified that this figure was negotiated down to 276,223 shares. [C. Palmer dep. 216.] The warrants from the second transaction would have entitled Heizer to 666,666 shares if the price had originally been pegged at $6 per share or 444,444 if pegged at $4 per share. At this point the parties apparently split the difference on price and triggered at $5 per share or 555,555 shares.

[Def. Ex. 78.] Because it appeared that $1,500,000 would be needed before such an offering could be made, McCormick also agreed to attempt to locate private investors. By November, these efforts had not proved successful and IDC's financial situation was desperate. Again, IDC looked to Heizer for an interim financing of up to $600,000 to be repaid from the private placement, which was now expected to materialize in January. [Tr. 179-180, 995, 1620.] An agreement was reached whereby Heizer would lend IDC up to $600,000, payable on demand after March 31, 1972; if the full amount had been lent and not repaid by that date, the loan would become convertible to common stock at $1 per share.[7] At that point the antidilution clauses in the warrants from the previous three transactions would be triggered and Heizer would become entitled to 4,694,400 shares of IDC common stock at $1 per share, or approximately 85 per cent of the corporation's equity.

The resignation of two directors from the IDC board[8] and the absence from the country of another, who was Beneficial's representative, left only four participating directors, two of whom were Heizer nominees, when a board meeting was held on November 19, 1971. Because of their conflict of interest, the Heizer nominees allowed the two independent directors to vote first, after telling them that there would be no transaction if either of them disapproved. The vote was unanimous in favor of the proposal.

Once the board had approved this fourth transaction, it was necessary to obtain the common shareholders' approval of a

7. Heizer vice-president, and IDC director, Charles Palmer testified that the purpose of the $1 conversion price was to provide IDC with a strong incentive to obtain outside financing or, in the event the financing fell through, to give Heizer what it considered to be a fair percentage of the company's equity. [C. Palmer dep. 137-138, 148-150.]

8. Edgar Heizer testified that he had refused to consummate the transaction unless one of these two, Glenn DeKraker, was removed from both the board and his position as president of the company. [Tr. 1009.]

charter amendment increasing the number of authorized shares of common stock from three to seven million. Counsel for Heizer and for IDC testified that, because of the company's pressing need for immediate financing, they decided that the best procedure was to obtain written consents from a majority of the stockholders, as permitted by the law of Delaware, the state in which IDC was incorporated. [Tr. 1135, 1629-1630, 1784.] Because Beneficial opposed the transaction, the consents had to be secured from Jordon Ross and his friends and business associates. Ross made the necessary contacts himself, obtaining consents from shareholders (including plaintiff Peter Wright) holding 52.4 per cent of the corporation's outstanding common stock.

In December 1971 McCormick & Co. informed IDC that it would not be able to arrange financing. One month later it became apparent that film monitoring was not technically feasible. After a period of re-evaluation, Heizer decided that the monitoring effort should focus on the feasibility of videotape monitoring, and, so limited, should be continued while a search for new management was conducted. [Def. Ex. 95, 100-101, 103-108, 111-112.]

By March 13, 1972, IDC had borrowed the entire $600,000 authorized in the fourth transaction and was again in need of funds. At that point, the IDC board, with the Beneficial nominee dissenting, authorized an amendment to the November 19th agreement whereby Heizer would lend the company up to $250,000 more and the amount lent, plus unpaid management fees and interest, would also become a loan convertible to common stock at $1 per share if not paid by March 31, 1972. On March 31 IDC had not repaid any of these loans, and Heizer therefore gained the right to purchase 5,513,908 shares of IDC common stock, or 87 per cent of the company's equity on a *pro forma* basis, at $1 per share.

A new board of directors, consisting of three Heizer nominees, a representative of Beneficial, and Jordon Ross, was elected in

May 1972. The Beneficial director, however, resigned less than a month later. In June 1972, Paul Roth was elected president of the company by the three Heizer directors voting in Jordon Ross' absence and apparently over his objections. Roth was given six months to study the viability of a videotape-only monitoring system. [P. Roth, Tr. 301.] In the meantime, from April 14, 1972 to April 19, 1973, Heizer extended $2,015,000 in non-convertible demand loans to IDC to make up the difference between its operating losses and T&R's profits.

In October 1972, Beneficial and Peter Wright, an individual shareholder, filed this derivative action. In their complaint, twice amended, they alleged that Heizer had effectively gained control of IDC through the protective provisions of the first transaction and had then violated Rule 10b-5 by failing to disclose to IDC's shareholders its controlling position and the unfair valuation placed on IDC stock in the second, third, and fourth transactions. Alternatively, they alleged that Heizer, if not in control of IDC, had aided and abetted IDC's management in its failure to disclose material facts concerning the four transactions. They also alleged that Heizer was liable as a controlling person for the actions of its nominees on the IDC board in voting for the allegedly unfair and improperly disclosed fourth transaction.

In June 1973, while this case was pending, the fifth transaction now complained of was consummated. Paul Roth and Heizer officers testified that they had found it impossible to arrange outside financing without recapitalizing the corporation. Once this suit was filed, recapitalization, which would have involved exercise of the disputed warrants, also became impossible. Heizer was thus left as IDC's sole source of financing. Edgar Heizer testified that because Heizer Corp. is not in the business of making unsecured loans, it was at that point "totally justified" in demanding security for its continued support of the business—even though its investment was not in any immediate danger. [Tr. 933, 936-937.] The security it received for all its loans after April 14, 1972 was a pledge of all the stock of T&R. In return,

Heizer agreed to postpone demand on the various short-term and demand loans extended pursuant to, and after, the fourth transaction until January 1974 and agreed to lend the company a minimum of $460,000 and a maximum of $1,181,700 during the remainder of 1973, also to be secured by the pledge and payable in January 1974.

Paul Roth testified that he was told one purpose of the pledge was to "smoke [plaintiffs] out of the woodwork," [Tr. 1291] apparently by threatening to foreclose on IDC's most profitable asset, T&R. In count II of their second amended complaint, plaintiffs challenged this pledge transaction, alleging that Heizer had demanded the pledge as protection against the outcome of the litigation and that this use of its control over the corporation constituted a manipulative and deceptive device operating as a fraud on IDC in violation of Rule 10b-5.

B. *The District Court Opinion*

In *Wright* v. *Heizer Corp.*, 411 F.Supp. 23 (N.D. Ill. 1975), the District Court held that plaintiffs could maintain a derivative action on behalf of IDC but ruled that, in light of the Supreme Court's re-affirmance of the *Birnbaum* purchaser-seller standing requirement in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), they could not sue personally as shareholder-investors in IDC. The court then ruled that the first three transactions, which it found to be "open and at arm's length," could not be attacked on the ground that they had not been fully disclosed to the shareholders because under the *Blue Chip* limitation "[t]his theory of fraud by concealment practiced on the shareholders" was not available. 411 F.Supp. at 36. The court went on to hold, however, that even if the theory were available, plaintiffs had failed to provide proof of nondisclosure.

With respect to the fourth and fifth transactions, the court held that because Heizer was a fiduciary engaged in self-dealing in the sale of securities, it had the "heavy burden of proving

[the] fairness" of those transactions. *Id.* Finding its proof inadequate, the court ordered the notes from the fourth transaction declared nonconvertible, cancelled any warrants issued in connection with that transaction, declared void the triggering of the prior warrants, and cancelled the pledge of T&R stock. Heizer was also enjoined from purchasing securities from or lending money to IDC in the future under conditions that were not "fair and equitable."

On appeal, plaintiffs do not challenge the District Court's ruling on the first three transactions. By means of the appeal in No. 76-1700 from an order denying a petition for supplemental relief, they challenge the scope of the relief granted, arguing that the court also should have forced Heizer to assume a portion of IDC's monitoring losses by requiring it to give up its senior position. In No. 76-1140, Heizer challenges the court's ruling on liability under 10b-5; it also argues that, even if that ruling was correct, the court erred in granting overly broad prospective relief. Finally, in No. 76-1702, Heizer appeals from an order entered after the District Court's decision, enjoining it pending appeal from proceeding with a proposed recapitalization plan.

C. *The Applicable Law*

In voiding the unfair portions of the fourth and fifth transactions, the District Court held that a "breach of trust by corporate fiduciaries clearly falls within [the] ambit" of Rule 10b-5. 411 F.Supp. at 35. The court then found that the Heizer nominees were directors whose votes were necessary to the approval of the transactions and therefore imposed on the defendant the burden of proving that its self-dealing had been fair. *Cf. Schlensky* v. *South Parkway Building Corp.*, 19 Ill. 2d 268, 166 N.E.2d 793 (1960). On appeal, plaintiffs did not seek to support the District Court's judgment with the fairness analysis the Second Circuit adopted in *Green* v. *Santa Fe Industries, Inc.*, 533 F.2d 1283 (1976), decided by that court

after Judge Marshall's decision and reversed by the Supreme Court after oral argument before us in the case at bar, *Santa Fe Industries, Inc.* v. *Green*, 97 S.Ct. 1292 (1977). See also *Marshel* v. *AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir.), *vacated and remanded for a determination of mootness*, 97 S. Ct. 228 (1976). Perhaps anticipating the Supreme Court's reversal in *Green*, plaintiffs instead advanced an argument similar to the District Court's rationale. They argued that self-dealing by a corporate fiduciary that results in the sale of securities for a grossly inadequate consideration has been considered fraud in connection with the sale of such securities since the Second Circuit's *en banc* decision in *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (1968), *cert. denied*, 395 U.S. 906 (1969), and in this circuit since the decision in *Jannes* v. *Microwave Communications, Inc.*, 461 F.2d 525 (1972). See also *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). Thus, they argued, findings of a fiduciary duty and gross unfairness in the price of securities sold to the fiduciary are sufficient to establish liability under Rule 10b-5, without proof of deception or nondisclosure of material facts.

In light of the Supreme Court's decision in *Green*, the District Court's reasoning cannot stand, and the plaintiffs' argument must be rejected. In *Green* the Court pointed out that *Schoenbaum*, and the cases following it, all "involved an element of deception," 97 S.Ct. at 1301 n.15, and thus "do not support the proposition . . . that a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure, violates the statute and the Rule." *Id.* at 1302. Moreover, in interpreting § 10b of the 1934 Act and Rule 10b-5 thereunder, the Court held that "once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute." The Court said that "[A]bsent a clear indication of congressional intent," it was "reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities" in order

to create a parallel federal remedy for unfairness. *Id.* at 1303-1304.

While attempting to support the District Court's reasoning in the case at bar, plaintiffs have also argued that Heizer is liable under Rule 10b-5 because it deceived the IDC stockholders, and thus IDC itself, by not informing them of the terms of the fourth and fifth transactions. Heizer has replied to this argument, both here and in the District Court. We are of course free to affirm the District Court's judgment on grounds other than those relied upon by that court.[9] *Dandridge* v. *Williams*, 397 U.S. 471, 475 n.6 (1970).

D. *Violation of Rule 10b-5: Duty to Disclose and Materiality*

1. *The Fourth Transaction*

In *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), Judge Augustus Hand established the familiar principle, since adopted by the Supreme Court, *Blue Chip Stamps* v. *Manor Drug Stores, supra*, 421 U.S. 723, that only a defrauded purchaser or seller has standing to sue under Rule 10b-5. A corporation issuing securities, such as the warrants here, is a "seller" of those securities for purposes of the *Birnbaum* rule, and its interest may be asserted in a derivative action. *E.g.*, *Dasho* v. *Susquehanna Corp.*, 461 F.2d 11 (7th Cir.), *cert. denied*, 408 U.S. 925 (1972). When no shareholder approval is required for the transaction, disclosure

9. We are not persuaded by plaintiffs' argument that the District Court made findings of fact on the issues of disclosure and control. In denying defendant's motion to dismiss at the close of plaintiffs' case, Judge Marshall did say that he believed "the evidence at this posture of the case would warrant findings in favor of the plaintiffs with respect to nondisclosure, control by Heizer, unfairness with respect to the fourth transaction and the pledge agreement." But he also stated that he had not "by any means started to make up [his] mind on the total merits of the case" and had not weighed the evidence. [Tr. 1518-1519.] Inasmuch as the judge did not mention these issues in his published opinion, we cannot treat these remarks as findings of fact subject to the "clearly erroneous" rule.

to the board of directors is disclosure to the corporation, at least when, as here at the time of the fourth transaction, a majority of the board is disinterested. *Dasho* v. *Susquehanna Corp., supra,* 461 F.2d at 24-26. Compare *Bailey* v. *Meister Brau, Inc.,* 535 F.2d 982 (7th Cir. 1976). When shareholder approval is required by state corporation law, however, it is the shareholders who represent the corporation and it is they who are entitled to disclosure of all material facts. See *Dasho* v. *Susquehanna Corp., supra,* 461 F.2d at 24; *Popkin* v. *Bishop,* 464 F.2d 714, 720 (2d Cir. 1972); Sherrard, *Fiduciaries and Fairness Under Rule 10b-5,* 29 Vanderbilt L. Rev. 1385, 1427 (1976).

In the case at bar, one critical element of the fourth transaction, the charter amendment increasing the number of authorized shares of common stock from three to seven million, required shareholder approval.[10] Under Delaware law, such an amendment must be approved by a majority of the common shareholders voting as a class. Del. Code Ann., Title 8, § 242 (c)(1) and (c)(2). Because Heizer held no common stock, never having exercised any of its warrants, this requirement meant that IDC's independent shareholders had the power to refuse the amendment and thereby block the entire transaction. Before deciding whether to exercise this power, the shareholders were entitled to full disclosure of all material facts concerning the transaction.

The record indicates that full disclosure was not made. The form of consent that plaintiff Peter Wright and other shareholders signed and the notice to shareholders who had not

10. Without the amendment, IDC would have been able to issue warrants for only 2.16 million, instead of 4,694,400, shares (three million minus the approximately 840,000 shares held by independent shareholders). Thus, Heizer could not have obtained a warrant exercise price of less than $2.20 or a *pro forma* equity position greater than 72 per cent. And, so long as the three million share ceiling was maintained, additional convertible investments would have merely increased the price per share rather than the number of shares purchasable.

signed were uninformative, stating only that the number of common shares would be increased from three to seven million by action of the shareholders voting as classes. Jordon Ross, who obtained all but one of the consents, testified that he told most of the shareholders he spoke to that the amendment was necessary for financing. The meetings were conducted hastily and the only information he volunteered to anyone was the amount of the financing involved. [Tr. 230-233.] Wright corroborated Ross' account, testifying that Ross did not tell him Heizer was the source of the financing or that the deal involved anything more than a simple purchase of stock. [Tr. 1405.]

In arguing a motion to dismiss at the close of plaintiffs' case in the District Court, Heizer contended that this disclosure was sufficient. From the documents submitted to them, the shareholders knew that there was a possibility that their equity position could be seriously eroded. Heizer argued that this knowledge should have prompted them to solicit more information from Jordon Ross, who presumably had ready access to all the material facts.

We find this argument unpersuasive. Although the shareholders knew that dilution was a possibility, they did not know what the terms of the transaction were, how Heizer had arrived at the $1 per share valuation, or what alternative would be available to IDC if the transaction could not be consummated. Despite the reference to voting by classes, there is no evidence that the shareholders knew that a majority of their votes were necessary for passage of the amendment: knowing, as they apparently did, that Heizer was a major power in the corporation, they may have assumed that the 300,000 votes indicated for Heizer at the bottom of the consent form were sufficient to carry the proposal. All these facts would be "material" in the sense that "there is a substantial likelihood that a reasonable shareholder would consider [them] important in deciding how to vote." *TSC Industries, Inc.* v. *Northway, Inc.,* 426 U. S. 438, 499 (1976). Indeed, without this information the shareholders

could not possibly have made an intelligent decision on the proposed charter amendment. To impose a duty of inquiry on them under these circumstances would be to encourage concealment rather than the full disclosure Rule 10b-5 requires.

Although Heizer did not control the IDC board at the time of the fourth transaction, it assumed responsibility for the inadequacy of the disclosure when it undertook to control and supervise IDC's communications to its shareholders. Heizer's counsel, Bernard Kury, testified that he drafted the closing documents for all four transactions, as well as whatever board or shareholder resolutions he considered necessary for IDC's approval of the transactions. In the second and third transactions, when he found notices of IDC shareholder meetings, prepared by IDC counsel and mailed without his prior approval, to have been inadequate, Kury himself drafted waiver of notice forms and directed IDC counsel to have them signed by all the shareholders. [Tr. 1092, 1105, 1109.][11] In the fourth transaction he drafted the shareholder consents approving the increase in the number of authorized shares, as well as the notice of shareholder action that was mailed to those who did not sign the consent form.

In the first three transactions Heizer was a lender to, and shareholder of, a corporation it did not control and on whose board it was not represented. We may assume that as such it was entitled to act solely in its own interest in dealing with IDC's management, whose responsibility it was to advise the shareholders. By the time of the fourth transaction, however, Heizer had gained voting control of IDC and had placed two of its officers on IDC's board of directors. Thus it stood in a fiduciary position and could no longer act for itself alone. When Heizer chose to continue its participation in communications to the IDC

11. Letters from Kury to IDC's counsel indicate that Kury closely supervised the process of obtaining these waivers, at one point requiring IDC counsel to go back to some shareholders who had replied by telegram to obtain their written signature. [Pl. Ex. 26-28.]

shareholders, it owed them the duty of full disclosure. As we have already noted, Heizer breached that duty by failing to disclose any of the material facts concerning the transaction.

2. *The Pledge Transaction*

We turn now to the fifth, or pledge, transaction. Delaware law specifically provides that no shareholder approval is necessary to pledge a corporation's assets. Del. Code Ann., title 8, § 272. Therefore, under Rule 10b-5 disclosure to IDC's board of directors would be sufficient, unless Heizer controlled the board to such an extent that only the independent shareholders were able to safeguard the corporation's interests. *Bailey* v. *Meister Brau, Inc., supra,* 535 F. 2d at 993. See also *Dasho* v. *Susquehanna Corp., supra,* 461 F. 2d at 26.

Although the District Court made no findings to that effect, the record indicates that Heizer controlled three of the four members of IDC's board for purposes of the pledge transaction. Two directors were Heizer nominees. The third was Paul Roth, who had recently been hired as president of IDC by the Heizer directors, over the objection of the fourth director, Jordon Ross. Heizer's control over Roth is apparent from his trial testimony that, although he was unsure why Heizer wanted the pledge from a business standpoint.

> "I was pretty much convinced that Heizer, you know, would insist on the pledging of the stock, and that I didn't have a hell of a lot of alternative short of resigning if it came to a matter of the pledge agreement." [Tr. 1326.]

It is clear that Roth was not alone in his perception of the situation: Edgar Heizer himself acknowledged that his company had assumed control of IDC when Jordon Ross (in his opinion irresponsibly) refused to hire Roth. [E. Heizer, Tr. 980.]

When an entire board of directors is controlled by a self-dealing director or shareholder the corporation can only be represented by the independent shareholders, to whom full disclosure must be made. See, *e.g., Dasho* v. *Susquehanna Corp.,*

supra, 461 F. 2d at 26; *Schoenbaum* v. *Firstbrook, supra,* 405 F. 2d at 219-220; *Pappas* v. *Moss,* 393 F. 2d 865, 869 (3d Cir. 1968); *Ruckle* v. *Roto American Corp.,* 339 F. 2d 24, 26, 29 (2d Cir. 1964). Conversely, where disinterested directors constitute a majority of the board of directors, disclosure to the board is sufficient. *Dash* v. *Susquehanna Corp., supra,* 461 F. 2d at 25. We are not aware of any prior case in which the court has confronted the issue of who represents the corporation in the middle situation presented here, where a majority, but not all, of the directors are controlled.

In the first *Dasho* v. *Susquehanna Corp.,* 380 F. 2d 262, 270 (7th Cir.), *cert. denied,* 389 U. S. 977 (1967), however, Judge Fairchild, concurring in the court's holding that the complaint stated a cause of action, observed that it would not be "sound to differentiate between situations where the directors were unanimous in their wrongdoing and those where less than all were involved." And in *Bailey* v. *Meister Brau, Inc., supra,* 535 F. 2d at 993, the court, while dealing with a situation in which the board was completely controlled, stated the general principle of law as follows:

> "Where the controlling stockholder causes the corporation to engage in a securities transaction in which the stockholder has a conflict of interest, it has the obligation to disclose to the other stockholders information in its possession which reflects on the fairness of the transaction."

Whether this rule, which is somewhat broader than the facts required, is to be automatically applied in all the cases it appears to describe, we need not decide. It should be applied here, where the lone minority director did not represent the interests of the second largest common shareholder and was completely excluded from the negotiation of the transaction. Under these circumstances, Heizer was obliged to disclose the material facts concerning the transaction to the independent shareholders prior to its consummation. This obligation was not fulfilled: the shareholders were first informed of the general terms of the pledge and the reasons therefore two months after the transaction. Thus, we hold that Rule 10b-5 was also violated by Heizer's failure to disclose material facts to the corporation in the fifth transaction.

E. *The Private Cause of Action: Reliance and Scienter*

In addition to proof of a technical violation of Rule 10b-5, a plaintiff in a private action based on the rule must also prove two elements traditionally associated with a common law action for fraud: he must show, first, that the defendant caused the alleged harm by inducing him to rely on material misstatements or misrepresentations and, second, that, in doing so, the defendant intended to deceive, manipulate, or defraud. *Ernst & Ernst* v. *Hochfelder,* 425 U. S. 185 (1976).

1. *Reliance*

In the ordinary 10b-5 case involving a failure to disclose, proof of materiality is sufficient to establish reliance. *Affiliated Ute Citizens* v. *United States,* 406 U. S. 128, 153 (1972). In other words, courts will not attempt to determine whether the individual investor, once fully informed, would have refused to consummate the proposed transaction. Instead, reliance is presumed if the omitted information "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries, Inc.* v. *Northway, Inc., supra,* 426 U. S. at 449.

In the transactions before us, in which the corporation itself is the "reasonable investor," we have held that the minority shareholders represented the corporation for 10b-5 purposes. If these shareholders would have been powerless to prevent the proposed self-dealing by the controlling shareholder even if they had possessed knowledge of all the facts, the failure to disclose to them would presumably be immaterial and reliance could not be shown. See *Santa Fe Industries* v. *Green, supra,* 97 S. Ct. at 1301 n.14. But that was not the case with either the fourth or fifth transactions in the case at bar.

In the fourth transaction, the shareholders had the power under state law to veto the transaction entirely. Thus, under the rationale of *Affiliated Ute Citizens*, proof of materiality is sufficient to establish reliance. *Cf. Mills* v. *Electric Auto-Lite Co.*, 396 U. S. 375 (1970).[12] In the fifth transaction, the minority shareholders would have had the right to bring a derivative action in the state court on behalf of the corporation to enjoin any breach of Heizer's fiduciary duty to deal fairly with the corporation. In such an action, there would be a heavy burden upon the self-dealing fiduciary to demonstrate that the transaction was fair to the corporation. *Cf. Shlensky* v. *South Parkway Building Corp., supra,* 19 Ill. 2d 268, 166 N. E. 2d 793. Thus, again applying the principle underlying *Affiliated Ute Citizens,* in a 10b-5 action brought derivatively on behalf of the corporation by minority shareholders to whom the self-dealing controlling shareholder failed to make disclosure, if the controlling shareholder cannot demonstrate that the transaction is fair to the corporation, the requisite materiality is shown and reliance is to be presumed.[13] The minority shareholders are thus afforded the same right they would have had if full disclosure had been made, *i.e.*, the right to obtain a judicial determination of the fairness of a transaction forced upon the corporation by a controlling shareholder with a conflict of interest. The existence of a causal link between Heizer's technical violation of Rule 10b-5 and the consummation of the pledge transaction depends, therefore, on the fairness of the transaction.

Heizer argues that the pledge should be sustained because it had no obligation to extend a loan to IDC and without the

12. In *Mills,* the Court held that proof of unfairness is not required to show that plaintiffs relied on misrepresentations in proxy materials. In footnote 7 of its opinion, 396 U.S. at 385, the Court specifically reserved the question of what standard would be applied in cases where the majority had sufficient voting strength to carry the proposal but nevertheless sought proxies from the minority through proxy statements containing material misstatements or omissions.

13. A fairness analysis has always been applied in 10b-5 derivative actions, see, *e.g., Schoenbaum* v. *Firstbook, supra,* 405 F.2d at 219; *Bailey* v. *Meister Brau, Inc., supra,* 535 F.2d at 993, although without any articulation of the basis for doing so.

pledge it never would have loaned the funds necessary to continue the monitoring business. It is at least doubtful, however, that Heizer would have chosen to sacrifice the profit potential of that business, in which it had already invested $5.5 million, merely because it was denied a pledge which, by its own admission, was not necessary to secure repayment of its loans. [Tr. 933, 936-937.] But more importantly, Heizer forgets that, in view of its conflict of interest, once it chose to deal with IDC, it had an obligation under state law to structure the transaction in a manner consistent with its duty to "protect and preserve the corporation. . . . maintain[ing] a high standard of loyalty to [it]." *State ex rel. Farber* v. *Seiberling Rubber Co.*, 53 Del. 295, 168 A.2d 310 (1961). In light of this obligation, its attempt to divorce its role as a creditor from its role as a fiduciary, in a transaction that required its consent in both capacities, cannot succeed. See *Todd* v. *Temple Hospital Association, Inc.*, 273 P. 595, 597, 96 Cal.App. 42 (1928). Allowing such a sleight of hand would render a fiduciary's duty of fair dealing meaningless whenever the corporation he served was in financial straits, because he could defend his conduct, as Edgar Heizer did on the witness stand in this case, by arguing that in his role as a fiduciary he was powerless to resist the demands he himself had made in his role as a creditor.[14]

Given the obvious risks of unfairness created by Heizer Corporation's limited view of its fiduciary responsibility, the presumption of unfairness applied by the District Court was particularly appropriate. As the court noted, Heizer's explanations for the pledge did not overcome that presumption. Heizer sought to justify the pledge first as a device to discourage what it considered to be a nuisance suit, which, by calling into question Heizer's right to exercise its warrants to purchase common stock,

14. Heizer stated: "Well, it's very hard, as you know, to separate your hats, but the way I had to look at it from Heizer Corporation's standpoint first, it was totally justified that we have security.

"Then, wearing my IDC hat as a director, I don't have very much choice. . . . I knew what Heizer Corporation would do if I didn't agree to give the security to Heizer Corp." [Tr. 933-934.]

prevented IDC from effecting the recapitalization it needed in order to attract outside financing. Assuming that IDC genuinely needed such protection, nevertheless Heizer's method of discouraging the suit was inconsistent with its duty to deal fairly with the minority. In threatening foreclosure on the pledge, Heizer was threatening to use a power acquired through its control of the corporation for the purpose of excluding the independent shareholders from further participation in IDC's business. Such a "freeze out" of the minority would appear to be a breach of fiduciary duty under Delaware law. See *Condec Corp.* v. *The Lunkenheimer Co.*, 43 Del. Ch. 353, 230 A.2d 769, 775 (1967).

The second explanation Heizer advances for the pledge does not even purport to be connected with IDC's welfare. Plaintiffs' suit threatened the flexibility Heizer had gained through the first four transactions, to maintain its senior position or to convert its holdings into common stock: if plaintiffs were successful and Heizer was prohibited from exercising its warrants at what it considered to be a reasonable price, Heizer would be effectively locked into a senior position. Edgar Heizer testified that, under those circumstances, it would want to have the kind of security a conservative lender, such as a bank, would require to cushion its investment.

Under Delaware law, Heizer would have breached its fiduciary duty by using its power over the corporate machinery to effect a transaction intended solely to maintain or increase its control over the corporation. See, *e.g.*, *Bennett* v. *Propp*, 41 Del. Ch. 14, 187 A.2d 405 (1962). In this case Heizer's conduct in using its control of IDC to protect itself in the event that it was found to have deceived the corporation was at least equally improper. Thus, we agree with the District Court's conclusion that the pledge was unfair and find the element of reliance to have been properly established in the fifth, as well as the fourth, transaction.

2. *Scienter*

The final element of a private cause of action under Rule 10b-5 is scienter, defined in *Ernst & Ernst* v. *Hochfelder, supra*, 425 U.S. 185, to exclude mere negligence. That case left open the question of whether recklessness is enough. In *Sundstrand Corp.* v. *Sun Chemical Corp.*, No. 76-1316, *et al.* (February 23, 1977). this court held that it is. See also *Sanders* v. *John Nuveen & Co.*, No. 74-2074, *et al.* (7th Cir. April 22, 1977) (*Sanders II*). The District Court in the case at bar, while characterizing Heizer's conduct in the fourth and fifth transactions as "rapacious," made no other findings concerning defendant's mental state in failing to disclose. The record, however, indicates that defendant's omissions were at least reckless.

In *Sundstrand* and again in *Sanders II* this court quoted with approval the definition of recklessness in the context of an omission in *Franke* v. *Midwestern Oklahoma Development Authority*, 428 F.Supp 719, 725 (W.D. Okla. 1976):

> "reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."

Heizer' failure to disclose any of the terms of the fourth transaction was "highly unreasonable." Heizer knew that the proposed transaction was controversial: a Heizer vice-president testified that during negotiations "Joe Mitchell [president of plaintiff Beneficial] screamed adamantly that he didn't think [it] was a fair deal," [Tr. 1968] and threatened suit if the transaction was consummated. Yet Kury, Heizer's counsel who had been delegated to oversee the approval procedure, did not include any mention of the transaction in the written consents or an adequate description of it in the notice to shareholders who had not signed, never gave Jordon Ross any instructions on what he should tell the shareholders when he orally

solicited their consents, and failed to ask Ross what he had said when he returned, approximately a day and a half later, with the signed consent forms. [Tr. 1144, 1147.] Instead, Kury and Heizer officers testified that they assumed the shareholders would know what was going on because they were Ross' friends and business associates [*e.g.*, E. Heizer, Tr. 734-737] and because, in the past, those who spoke at the shareholders' meetings had always appeared well-informed. [E. Heizer, Tr. 748.]

At trial IDC's outside counsel testified that Jordon Ross had told him and Kury that, because the shareholders were his friends, he would be able to get their signatures in the short period of time available. [Tr. 1785.] On its face this statement implies that consents would be solicited on the basis of friendship rather than on the basis of properly disclosed facts. The shareholders' natural tendency to trust Ross' judgment would be further enhanced by the fact that Ross, who was the single largest shareholder, would seem to be the most vitally concerned with the corporation's welfare. Heizer officers had already decided that Ross was a gifted salesman, with an unfortunate tendency, however, to be unrealistic about IDC and its prospects for acquiring outside financing. [See, *e.g.*, Pl. Ex. 66.] Thus, even if he did disclose some facts about the transaction, he could be expected to present them in the most attractive light possible. Under these circumstances, delegating Ross to solicit consents without any instructions whatsoever constituted "an extreme departure from the standards of ordinary care" that defendant should have observed in discharging its duty of insuring full and fair disclosure.

Heizer's conduct in the fifth transaction also bespeaks a reckless disregard of its duty to disclose. Heizer must have been aware that the pledge was for its own benefit and thus would arouse a great deal of opposition on the part of IDC's common shareholders. Yet it consciously decided, through Heizer counsel, not to take the proposal to the shareholders. The effect of this decision was to insure that at least plaintiff Beneficial,

who no longer had a representative on IDC's board of directors, would not learn of a transaction admittedly designed, in part at least, to discourage its suit until after its consummation. We think this is a case for the application of the reasoning of the distirct court, adopted by this court in *Bailey* v. *Meister Brau, Inc., supra,* 535 F.2d at 993:

> " '[B]linded by a conflict of interest, [defendant] wantonly ignore[d] evidence of the unfairness of [the] securities transaction to the corporation and therefore fail[ed] to disclose this evidence to those shareholders whose interests lie with the corporation.' "

F. *Relief*

1. *Unraveling Past Transactions.*

In granting relief in a case such as this, a court of equity should attempt to return the parties to the *status quo ante,* unraveling transactions effected through violations of Rule 10b-5 to the extent that it may do so fairly and without injuring the rights of innocent parties. See *Mills* v. *Electric Auto-Lite Co., supra,* 396 U.S. at 388. Heizer agrees that, if its conduct in the fourth transaction violated Rule 10b-5, the District Court was correct in cancelling the conversion feature of, and any price adjustment effected through, that transaction. Another consequence of the fourth transaction that may also be easily unraveled is the IDC charter amendment permitting an increase in the number of authorized common shares.

With respect to the fifth transaction, Heizer again agrees that the pledge should be nullified if its conduct in obtaining it was wrongful. We, however, would hold the pledge void even if Heizer's conduct in the fifth tranaction was not in itself actionable under Rule 10b-5. As we noted above, the pledge was designed to discourage the instant suit and to protect Heizer's position in the event it was found to have deceived the corporation. Thus, in a sense, the pledge was a consequence of the

violation, and, like other, more direct consequences, should be dispelled insofar as possible. Voiding the pledge would injure no innocent party and would be consistent with a state law fiduciary analysis, see *supra*. Therefore, whether as an independent violation or a consequence of the violation in the fourth transaction, the pledge was properly nullified by the District Court.

Pursuant to the improperly disclosed fourth and fifth transactions, Heizer also extended approximatley $3 million in short-term or demand loans to IDC. In his opinion, the district judge did not modify these obligations in any way, although he did enjoin Heizer from dealing unfairly with IDC in the future. After his opinion was filed, Heizer presented a recapitalization plan to IDC's common shareholders. In a proxy solicitation mailed to those shareholders, Heizer pointed out that "IDC does not have the financial resources necessary to repay all of the debts currently due and payable to Heizer," and threatened to put the company into bankruptcy if the plan was not approved.

On plaintiffs' motion, the district judge enjoined the consummation of this plan pending appeal, observing that the proposal itself appeared unfair. He also enjoined Heizer from collecting interest or principal on its loans to IDC.

Plaintiffs too complain of the District Court's disposition with respect to the demand loans. By way of a "Petition for Supplemental Relief," filed with the District Court on May 6, 1975, prior to the issuance of the court's opinion, but after the court had indicated to the parties what its decision would be, plaintiffs argued that these loans were in themselves an imposition on IDC's common shareholders and as such should be cancelled or reformed into common stock. In their petition plaintiffs also sought a permanent injunction to prevent Heizer from attempting to enforce any of the demand notes issued by IDC after November 19, 1971.

In May, 1975, the court stated that the petition would be taken under advisement. In its opinion issued on December 3,

1975, however, the court specifically denied one of plaintiffs' requests for relief, but failed even to mention the relief they had sought with respect to the demand loans. On January 6, 1976, plaintiffs attempted to reiterate their petition for supplemental relief by filing a motion to require defendant to answer. On May 28, 1976, after a remand from this court ordered for the purpose of enabling the District Court to rule on the petition and other still pending matters, that court finally denied plaintiffs' petition on the ground that it

> "was mooted by or merged into the December 3 decree and the renewed petition was an untimely effort to modify the decree. Rule 59(e), Fed. R. Civ. P."

Heizer argues that the District Court's finding of untimeliness or merger was correct and that, inasmuch as plaintiffs failed to appeal from the December 3rd decree, we are without jurisdiction to consider the merits of plaintiffs' claim. In our opinion as originally issued we stated, without giving reasons, that we agreed with this position. On further consideration, however, we believe we were incorrect. Inasmuch as neither the opinion nor the decree of December 3, 1975 mentioned the petition for supplemental relief and concededly did not dispose of the entire case (a finding under Rule 54(b), Fed. Rev. Civ. P. was included in the decree), and plaintiffs were not notified until May 28, 1976 of the District Court's view that it had ruled on the petition *sub silentio*, we think the decree should not be construed as having had that effect. It would be overly technical and unjust to hold that plaintiffs lost their right to appeal a ruling before they knew it had been made. Such a result is not required by anything in the Federal Rules of Civil Procedure and would be contrary to the admonition of Rule 1 that those rules "be construed to secure the just . . . determination of every action." We therefore consider the merits of the supplemental petition.

The loans themselves should not be subordinated unless it was unfair for Heizer to continue the monitoring business or to

finance that business by extending loans rather than by contributing equity capital. On the first issue, in the absence of a finding by the District Court, we cannot say that Heizer's continuation of the monitoring business, which after all also involved risk to itself, was unfair to the corporation or the minority shareholders. And, insofar as the second issue is concerned, there is no requirement under state law that a fiduciary who agrees to provide financing must do so by means of an equity investment. Thus, the only inquiry that remains is whether the terms of the loans, apart from the convertibility feature and the security that have already been nullified, were fair to IDC and its common shareholders.

The combined effect of the short-term or demand maturity features of the loans made after the third transaction was to give Heizer the right to obtain a lion's share of the equity in IDC if the monitoring effort was successful and, if that effort was not successful, the power to recoup promptly its entire investment by calling the loans and putting IDC into bankruptcy. It is perhaps not inconceivable that fully informed minority shareholders would have jeopardized their indirect interest in the valuable T&R business for the prospect of a small interest in the increasingly dubious monitoring venture, and, to gain that end, would have placed themselves at the mercy of Heizer by entering into the fourth transaction and the ensuing loans. This possibility is not enough, however, to satisfy the burden of the self-dealing controlling shareholder to demonstrate the fairness of this heads-I-win-tails-you-lose series of transactions. The maturity features of the loans were hardly consistent with Heizer's duty to deal fairly with the corporation and its shareholders. See *Baron* v. *Allied Artists Pictures Corp.*, 337 A. 2d 653, 658 (Del. Ch. 1975), *appeal dismissed*, 365 A. 2d 136 (1976). Thus, in order to unravel in an equitable manner the transactions resulting from Heizer's wrongful conduct, the maturities of the loans should be adjusted to make

them commensurate with IDC's ability to pay.[15] On remand, the District Court should make the necessary determinations and modify the terms of the loans accordingly.[16]

From this disposition, it follows that the District Court was correct in enjoining Heizer from seeking to collect its loans or coercing agreement to its recapitalization plan by threatening collection pending appeal.[17]

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15. This relief does not seem unduly harsh. The monitoring program has been dropped and T&R has always been a growing, profitable company; with T&R's earnings sheltered by IDC's loss carryovers, IDC should be able to pay back the loans eventually.

16. Ordering this relief is not inconsistent with the principle relied upon by Heizer in its petition for rehearing and declared in *Morley Construction Co.* v. *Maryland Casualty Co.*, 300 U.S. 185 (1937), that the rights of the appellee may not be enlarged in the absence of a cross-appeal. Statements made by the district judge at hearings on June 9 and June 18, 1975, and the relief granted by him pending appeal, *viz.*, enjoining Heizer from collecting or threatening to collect its loans, indicate that he believed efforts by Heizer to enforce the present maturities were forbidden by paragraph 5 of the decree, which permanently enjoins Heizer "from entering, directly or indirectly, into any transaction with IDC except upon such terms and conditions as shall be fair and equitable." He obviously viewed his prohibition, pending appeal, against enforcing the existing maturity provisions of the notes as not expanding that relief. In any event alteration of the maturities is within our power to order as a lesser included form of one kind of relief sought in the petition for supplemental relief, *viz.*, a complete prohibition against enforcement of those notes. The denial of relief under that petition is the subject of the appeal in No. 76-1700.

17. Heizer's procedural attack on that injunction is without merit. In light of our modification of the demand loans, Heizer was not prejudiced by the denial of "the chance to present expert witnesses to explain how the recapitalization plan operated and how it was fair to all parties concerned." The only relevant evidence, Heizer's communication to the IDC shareholders, was before the District Court. Heizer also argues that plaintiffs should have been required to post bond. As plaintiffs point out, however, it was defendant who was acting under a permanent injunction and who nevertheless sought to change the status quo. Moreover, in view of our affirmance of the District Court's order, any error in not requiring a bond would have been harmless.

2. *Prospective Relief*

Paragraph 5 of the decree permanently enjoins Heizer "from entering, directly or indirectly, into any transaction with IDC except upon such terms and conditions as shall be fair and equitable." Heizer argues that this provision is too vague to comply with the requirement of Rule 65(d), Fed. R. Civ. P., that "Every order granting an injunction . . . shall be specific in terms [and] shall describe in reasonable detail . . . the act or acts thought to be restrained," because it "cannot possibly know how to conform its conduct to Paragraph 5," which would require it "to try to predict whether its evaluation of its conduct will coincide with that [of] Judge Marshall—or whoever else might be called upon to judicially decide what is 'fair and equitable.' "

In determining the appropriate prospective relief, we must consider, on the one hand, the specificity requirement of Rule 65(d), on which Heizer relies, and, on the other, the difficulty of predicting the form of possible future undisclosed, unfair transactions which may result from Heizer's conflict of interest as the major creditor and controlling stockholder of IDC. There is a sufficient basis for the District Court's determination that some kind of restraint on future abuses is warranted, but Heizer must be specifically apprised of what is forbidden.

We must also consider whether an injunction requiring advance disclosure of any proposed transaction between IDC and Heizer would be sufficient, or whether the decree should address itself in any way to the substance of future transactions. Where the independent shareholders have the power under state law to approve or disapprove a transaction, fairness is, as we have said, irrelevant under Rule 10b-5. In that case, an injunction requiring full disclosure of all material facts concerning a self-dealing securities transaction would be sufficient. But where the self-dealing fiduciary controls the corporate voting machinery, the materiality of any future failure to disclose challenged under

Rule 10b-5 will depend, as we have also seen, upon its fairness. If such a transaction were challenged in an independent federal action, a determination of unfairness, coupled with the breach of the 10b-5 duty to disclose, would lead the federal court to prohibit or set aside the transaction. As is apparent from our approval of the unravelling of the fourth and fifth transactions, we do not view *Green* as requiring the federal court merely to declare the breach of the duty to disclose and send the plaintiff to the state court to remedy the unfairness. The preventive prospective relief should not be narrower in scope than the relief that could be obtained in a new federal action to remedy the future wrong.

In light of the foregoing considerations, paragraph 5 of the decree should be deleted, and Heizer should be enjoined from failing to disclose to the common shareholders any material facts concerning future transactions it proposes to enter into, directly or indirectly, involving securities of, or held by, IDC. Specifically, Heizer should be required to disclose all facts bearing on the fairness of such a transaction, including its own valuation of the company and its future prospects. Furthermore, Heizer should be enjoined from entering into, directly or indirectly, any securities transaction with IDC unless that transaction has been approved by a majority of the shareholders other than Heizer or, failing such approval, has been found to be fair and equitable by the District Court or another court having jurisdiction to make such a finding. The foregoing relief makes more specific but does not expand the relief granted by the District Court: Heizer will thus be able to avoid the necessity of obtaining judicial approval for its self-dealing, but will not be foreclosed from using its voting power to approve a fair transaction which the common shareholders have capriciously rejected.

Heizer also argues that the District Court's decree enjoins the future operation of its antidilution or price-adjustment clause in the warrants obtained in the first three transactions and

prohibits it from purchasing IDC stock, at any time in the future, for less than $3.60 per share. Plaintiffs read the District Court's order less broadly, arguing that it merely cancels the warrants in the fourth transaction and prohibits Heizer from using its price-adjustment provision unfairly in the future.

We think that the court's order is susceptible to the interpretation advanced by Heizer.[18] And we agree with Heizer that it would be inappropriate to limit the future warrant exercise price, in light of the District Court's determination, not challenged here, that the antidilution provisions in the first three sets of warrants were not improperly acquired. Moreover, as we have already held, federal law does not impose a limitation on the substantive terms of any future transaction which IDC's common shareholders are free to approve or disapprove.[19] On remand, the judgment will therefore be modified to so state.

18. Paragraph 2 of the decree, which plaintiffs quote in their brief, nullifies the future effect of warrants acquired through the fourth transaction and returns the parties to their positions prior to that transaction. Two subparagraphs, however, seem to go beyond a simple unraveling of the fourth transaction in permanently enjoining Heizer from

> "(a) Exercising or attempting to exercise, directly or indirectly, any warrants to purchase shares of common stock of IDC, at an exercise price of less than $3.60 per share; and
>
> (b) Issuing or attempting to issue, directly or indirectly, any shares of common stock of IDC at a price of less than $3.60 per share upon the exercise of any warrants held by Heizer Corporation . . . to purchase shares of common stock of IDC."

Paragraph 3 also seems to refer to the antidilution clauses of the first three transactions:

> "In any transaction . . . between Heizer Corporation . . . and IDC, from and after the date hereof, no provision contained in any agreement heretofore entered into which authorizes or permits an adjustment in the purchase price of any outstanding warrants to purchase IDC common stock, shall be of any force or effect. . . . Nothing herein contained shall prohibit Heizer Corporation from otherwise purchasing securities from or lending money to IDC under such terms and conditions as shall be fair and equitable."

The district judge's remarks at the June 18, 1976 hearing on plaintiffs' motion for an injunction pending appeal also indicated that he intended the decree to freeze the warrant exercise price at $3.60 per share.

II.

The Individual Claim

In No. 76-1701, plaintiff Beneficial appeals from the District Court's order of May 28, 1976 granting summary judgment to defendants on count III of the second amended complaint. In that count Beneficial alleged that in January 1969 it purchased a five-year, $435,000 debenture, convertible at its option to 21.25% of IDC's common stock. The agreement between Beneficial and IDC provided that

> ". . . it shall be mandatory upon BSC to convert the aforementioned debentures on or before the filing by IDC of the necessary documents and an 'S-1' statement with the Securities and Exchange Commission which sets forth that IDC earnestly desires and seeks to make a public offering of its common stock in a minimum amount of Two Million Dollars."

A notice provision was included, requiring IDC to serve Beneficial with a copy of its registration statement and resolutions authorizing it ten days before filing. Plaintiff submitted exhibits and affidavits showing that there was a verbal understanding that, if the debenture was converted to facilitate a public offering and no such offering was made, it would be reconverted to a debenture.

On July 8, 1969, plaintiff was told by an attorney representing IDC that it was necessary for it to convert immediately

19. The decree will not, of course, prevent a minority shareholder who contends that a proposed transaction is an unfair exercise of the self-dealing fiduciary's control from so asserting in a state court action, even though it has been approved by the other minority shareholders. The claims in this action being federal, the relief granted is designed only to vindicate federal rights.

in order for the public offering to progress. Plaintiff alleges that this representation was false[20] and was made

> ". . . in order to induce it to convert its debenture at its option, pursuant to the voluntary conversion provisions of said debenture agreement, and to make it unnecessary for IDC to invoke the mandatory conversion provision of said debenture agreement. The intent and purpose of IDC in so inducing BSC to voluntarily convert its debenture was to make such conversion irrevocable and to deprive BSC of its right to cancel and rescind such conversion in the event that the proposed public offering failed."

IDC filed a registration statement on July 23, 1969. The statement not having become effective by October 1st of that year, Beneficial demanded reconversion of its debenture. IDC assured it that the offering was proceeding and allegedly agreed to return the debenture if the offering did not go through. On November 1, 1970 Beneficial was informed that IDC's registration statement had been withdrawn. This action was filed on October 11, 1972.

In an unreported memorandum opinion the District Court granted IDC's motion for summary judgment on the grounds that, the fraud having been discovered on October 1, 1969, the action was barred by the three-year statute of limitations, Ill. Rev. Stat. ch. 121½, § 137.13(D), see *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123, 125 (7th Cir. 1972), and that, even if it were not barred, Beneficial had failed to establish a prima

20. Plaintiff also alleges that there were false representations that a firm underwriting agreement existed, that the registration statement would become effective, and that the public offering would be consummated. There was a letter of intent from an underwriting firm, conditioning its support of the offering on the effectiveness of the registration statement and general market conditions. Any representations as to future events would have to be based on similar assumptions of favorable market conditions and favorable business operations for IDC. Plaintiff, however, does not allege that the public offering was a sham intended to induce it to convert its debenture, nor does not allege any cause for IDC's failure to make a public offering. Rather, it rests its claim on the distinction between a voluntary and a mandatory conversion, discussed below.

facie case that it had been injured by the alleged misrepresentations. We affirm this ruling.

Plaintiff argues that IDC should be estopped from claiming that the action was time-barred because plaintiff was induced to forego filing suit by IDC's representations that it would reissue the debenture if there was no public offering. Even assuming that the facts support plaintiff's claim of reasonable reliance on an offer of settlement, we think the district judge was correct in finding that plaintiff was not injured by the alleged misrepresentation.

Plaintiff's contention that the conversion was not required by the mandatory conversion provision of the agreement, and was therefore "voluntary" and induced by misrepresentation, is based on IDC's failure to give the notice called for in that provision. The conversion was not voluntary in the sense that Beneficial had decided to convert for its own reasons. IDC was clearly invoking the provision of the contract requiring conversion in the event of a public offering. A defect in the notice or demand given by IDC would not affect the duty to convert. The failure to observe the notice requirement, had it been raised at the time, could have been cured. Beneficial, however, waived the notice requirement by not insisting upon it at the time of the transaction and proceeding without the required notice. The other conditions upon which a duty to convert would arise were satisfied within two weeks after the conversion took place.[21] Beneficial could not have been injured by being induced to do something which it would have been required to do two weeks later in any event. Any undertaking by IDC to allow reconversion might give rise to a claim under state law, but not under Rule 10b-5.

The District Court's decree of December 3, 1975 is in part affirmed and in part vacated with directions to modify. The

21. A registration statement as described in the agreement was prepared (and a draft was forwarded to Beneficial before filing) and filed with the SEC together with other necessary documents.

order of May 28, 1976 is affirmed insofar as it entered summary judgment in favor of IDC on Count III of the complaint and modified insofar as it dismissed the petition for supplemental relief. The case is remanded to the District Court for further proceedings consistent with this opinion. In Nos. 1140, 1700, and 1702, which were briefed together, plaintiffs shall recover costs against Heizer. In No. 1701, IDC shall recover costs against Beneficial.

ORDER OF THE COURT OF APPEALS, SEPTEMBER 9, 1977.

UNITED STATES COURT OF APPEALS

For the Seventh Circuit

Chicago, Illinois 60604

September 9, 1977.

Before

Hon. Latham Castle, *Senior Circuit Judge*
Hon. Philip W. Tone, *Circuit Judge*
Hon. Harlington Wood, Jr., *Circuit Judge*

PETER WRIGHT and BENEFICIAL STANDARD CORPORATION, *Plaintiffs-Appellants, Cross-Appellees,*	Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.
Nos. 76-1140, 76-1700, 76-1701 & 76-1702 vs.	No. 72-C-2536
THE HEIZER CORPORATION, *Defendant-Appellee, Cross-Appellant, and*	Prentice H. Marshall, Judge.
INTERNATIONAL DIGISONICS CORPORATION, *Defendant-Appellee.*	

These causes came on to be heard on the transcript of the record from the United States District Court for the Northern District of Illinois, Eastern Division, and were argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said District Court in these causes appealed from be, and the same is hereby: The District

Court's decree of December 3, 1975 is in part AFFIRMED and in part VACATED with directions to modify. The order of May 28, 1976 is AFFIRMED insofar as it entered summary judgment in favor of IDC on Count III of the complaint and modified insofar as it dismissed the petition for supplemental relief. The case is REMANDED to the District Court for further proceedings consistent with this opinion. In Nos. 76-1140, 76-1700 and 76-1702, which were briefed together, plaintiffs shall recover costs against Heizer. In No. 76-1701, IDC shall recover costs against Beneficial. The aforegoing is in accordance with the opinion of this court filed this date.

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PETER WRIGHT and BENEFICIAL STANDARD CORPORATION,
Plaintiffs-Appellants, Cross-Appellees,

Nos. 76-1140, 76-1700, 76-1701 & 76-1702

vs.

THE HEIZER CORPORATION,
Defendant-Appellee, Cross-Appellant, and

INTERNATIONAL DIGISONICS CORPORATION,
Defendant-Appellee.

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 72-C-2536

Prentice H. Marshall, *Judge.*

ORDER RULING ON PETITION FOR REHEARING.

The modified opinion and judgment of this date are ordered filed and entered.

The opinion and judgment heretofore filed and entered in this cause having been modified in the respects shown in the modified opinion and judgment, which supersede the original opinion and judgment, the petition for rehearing is denied except to the extent that any relief requested in the petition may be granted in the modified opinion.

OPINION OF THE DISTRICT COURT,
DECEMBER 3, 1975.

IN THE
UNITED STATES DISTRICT COURT
For the Northern District of Illinois
Eastern Division

PETER WRIGHT and BENEFICIAL STANDARD CORPORATION,
Plaintiffs,
vs.
THE HEIZER CORPORATION and INTERNATIONAL DIGISONICS CORPORATION,
Defendants.
No. 72 C 2536

MEMORANDUM DECISION.

This action presents questions concerning the class of persons who may maintain a private action for equitable relief under Rule 10b-5 of the Securities and Exchange Commission; the scope of the substantive provisions of that Rule; and the appropriate equitable relief to be granted in light of the violations of the Rule which have been proved.

The case was tried without a jury[1] prior to the Supreme Court's decision in *Blue Chip Stamps, et al.* v. *Manor Drug Stores,* 421 U.S. 723 (1975). There the Court gave limited

1. When plaintiffs withdrew their jury demand, defendant Heizer demanded trial by jury. Heizer's demand was denied because all of the relief sought is equitable and all of the issues of fact raised by the pleadings are of a nature which can be tried by a chancellor without a jury consistent with the Seventh Amendment. *Cf. Ross* v. *Barnhard,* 396 U.S. 531 (1970).

approval to the *Birnbaum*[2] purchaser-seller limitation on the class of persons entitled to seek money damages under Rule 10b-5. It is that limitation which gives rise to the threshold question of whether plaintiffs may maintain this action for equitable relief in view of the fact that they did not participate directly as either the purchasers or sellers of the securities involved in this action.

Our starting point will be the basic facts which are essentially undisputed. Jurisdiction is present under 15 U.S.C. §§ 78j and 78aa. This memorandum will stand as our findings and conclusions under Rule 52(a), *Fed. R. Civ. P.*

The Basic Facts

Plaintiffs, Peter Wright and Beneficial Standard Corporation are and at all material times have been minority common shareholders in defendant International Digisonics Corporation (IDC), a Delaware corporation. IDC and its wholly owned subsidiary Talent and Residuals, Inc. (TR), also a Delaware corporation, are engaged in two separate but related service businesses: IDC monitors television commericals as they are shown on the air to assure that the commercials are shown as agreed to by the television industry; TR performs the accounting and record keeping services necessary to the accurate and adequate compensation of the persons performing in the commercials. IDC and TR were organized in 1968 by Jordon Ross who is IDC's principal common shareholder and who, during most of the transactions complained of, was IDC's president and chief executive officer.

IDC's monitoring service has not prospered financially. The fact of this financial distress is of significance; the reasons for that distress are not and they were not fully developed at the trial. Suffice it to say that IDC has encountered technical electronic problems occasioned in part by the fact that some com-

2. *Birnbaum* v. *Newport Steel Corp.,* 193 F.2d 461 (2d Cir. 1952), *cert. denied,* 343 U.S. 956 (1952).

mercials are shown on film, others on video tape, some nationally, others locally.

In contrast, TR's talent accounting service has prospered financially. So much so that, as we shall see, it became the plum which defendant Heizer Corporation (Heizer) plucked as a hedge against Heizer's large investments in IDC's monitoring operation.

Heizer is a closely held investment company specializing in privately placed venture capital investments in new and developing industries and businesses. Many of its own investors are regulated institutions that could not invest directly in a new and developing business or industry because of the risk. Heizer and its investors hope to reap substantial profits from their venture investments. But their hopes are not always realized as the facts in this case show.

In November 1969, IDC was in need of cash for its monitoring business. It sought its needs from Heizer who invested $1,500,000 on the following terms.

Pursuant to a written agreement, IDC amended its certification of incorporation to create a new class of stock known as Class A common stock. Heizer purchased 100,000 shares of Class A common at $10 per share. IDC issued to Heizer a warrant to purchase 155,000 shares of IDC common at a basic purchase price of $8.50 per share, which contained an adjustment of purchase price ("anti-dilution clause") reducing the price to Heizer in the event IDC issued or sold any of its common shares at less than $8.50. Heizer agreed to lend IDC, at the latter's option, up to $500,000 with interest at 2% over prime. The agreement between Heizer and IDC contained rather typical disclosure, continuation of business, and non-merger, sale or encumbrance of assets clauses.

The documents embodying the agreement were presented to the IDC board of directors at a duly called meeting held November 5, 1969. The directors unanimously approved all the terms and conditions of the agreement and resolved to present

to the IDC stockholders the amendment to IDC's certificate of incorporation creating the Class A common stock.

The stockholders meeting was held immediately following the directors meeting pursuant to notice given the stockholders, which included a statement of the important terms of the proposed Class A common stock. In addition, prior to the meeting, the holders of approximately 80% of IDC's outstanding common stock, including plaintiff Beneficial Standard Corporation, had received from IDC copies of all of the documents relating to the total transaction with Heizer. A quorum of stockholders attended the meeting and the proposed amendment to the certificate of incorporation was unanimously approved by those in attendance. On November 6, 1969, the first transaction was closed. On May 25, 1970, pursuant to the first transaction, Heizer loaned IDC $500,000 until May 25, 1971 with interest at 2% over prime.

In the summer of 1970 IDC was again in need of cash for its monitoring business and it approached Heizer to make an additional investment for the monitoring business. On September 1, 1970, IDC and Heizer entered into and executed an agreement which culminated in Heizer's investment of $2,000,000. The agreement provided that IDC would again amend its certificate of incorporation, this time to authorize 350,000 shares of a new class of preferred stock with certain rights and preferences, the most significant of which was a weighted vote of 4.4 per share on all shareholder votes. Heizer was to exchange the 100,000 shares of its previously purchased Class A common for 100,000 shares of the new preferred. IDC was to sell Heizer an additional 200,000 shares of the new preferred at $10 per share in two takedowns of $1,000,000 each. Upon completion of the second takedown, IDC was to issue to Heizer an additional warrant to purchase 400,000 shares of IDC common at a basic purchase price of $6 per share, with an anti-dilution clause comparable to the first warrant. The protective provisions regarding continuation of business, etc., were, of course, repeated.

The documents evidencing the second transaction were presented to the IDC board of directors at a meeting duly called pursuant to notice on August 31, 1970. At that meeting a majority of the IDC directors were present and those present unanimously approved the terms and conditions of the second transaction and resolved to present to the stockholders the proposed amendment to IDC's certificate of incorporation creating the new preferred stock.

On August 5, 1970 IDC had mailed a notice of a special meeting to stockholders calling the meeting for September 1, 1970. The notice was not accompanied by any enclosures, attachments or documents relating to the second transaction but it did state the shareholders would "review, consider and vote upon the financing propositions." Furthermore, prior to the September 1, 1970 stockholders meeting, the holders of approximately 54% of IDC's outstanding common stock received copies of all of the documents relating to the second transaction. Pursuant to the notice, the special meeting of stockholders was held. A quorum of a majority of the stockholders was present. By a unanimous vote of those present and voting, the new preferred stock was approved as was the second transaction.

In February, 1971, the second transaction was fully consummated to the end that Heizer was then the owner of 300,000 shares of the new preferred stock, one warrant to purchase 150,000 shares of common at $8.50 per share, a second warrant to purchase 400,000 shares of common at $6 per share and IDC's note for $500,000 due May 25, 1971.

In the spring of 1971, IDC again approached Heizer to make yet another investment to provide IDC with funds to purchase more monitoring equipment. On May 13, 1971, IDC and Heizer executed an agreement which became the third transaction. It provided for an amendment to IDC's certificate of incorporation to increase the authorized common stock to 3,000,000 shares, the sale by IDC to Heizer of a 20-year senior note in the principal amount of $1,700,000, the issuance by IDC

to Heizer of an additional warrant to purchase 472,222 shares of IDC common at $3.60 per share and an adjustment in the purchase price under the warrants issued in the first two transactions so that they could be exercised for common stock at a price of $3.60 per share. The effect of the price adjustment was not, however, limited to a reduction in the purchase price per share under the first two warrants. It also increased the number of shares of common purchasable at the reduced price. Thus, under the first warrant Heizer could now purchase 276,223 shares of common at $3.60; under the second 555,555 at $3.60; under the third 472,222 at $3.60; all to the end that at the conclusion of the third transaction it could purchase 1,304,000 shares of common at $3.60 per share.

The documents regarding the third transaction were presented to the IDC board of directors at a meeting duly called pursuant to notice on May 11, 1971. At that meeting a majority of IDC's directors were present and those present unanimously approved the terms and conditions of the third transaction and resolved to present to the stockholders the necessary amendment to IDC's certificate of incorporation.

Prior to May 11, 1971 IDC had mailed a notice of its annual meeting to its stockholders calling for the meeting on May 11. Prior to that date the holders of approximately 73% of IDC's outstanding common stock, including the plaintiff Beneficial Standard Corporation, received from IDC copies of all documents relating to the third transaction.

Pursuant to the notice, a meeting of the stockholders of IDC was held on May 11. A quorum of a majority, but not all of the stockholders was present, and by a unanimous vote of all the stockholders present and voting, the third transaction was approved. At that meeting of stockholders, the following persons were elected directors of IDC: Jordon I. Ross, chairman of the board and chief executive officer; Glenn M. Dekraker, president of IDC and its chief operating officer; Marcus Loew II, vice president and treasurer, Beneficial Standard Life In-

surance Co., representing Beneficial Standard Corp.; Edgar F. Heizer, Jr., president, Heizer Corporation, representing Heizer Corporation; Charles L. Palmer, finance vice president, Heizer Corporation, representing Heizer Corporation; Ronald Labow, managing partner Cerebrus Fund, an independent director; Douglas F. Johnston, executive vice president for Investments, Title Insurance Corporation of California, an independent director.

Following the amendment of IDC's certificate of incorporation in connection with the third transaction, IDC's capital structure and the voting rights of its shareholders were: common stock, 3,000,000 shares authorized, 840,010 issued and outstanding and entitled to one vote per share, or 39% of the total votes at a shareholders meeting; preferred stock, 350,000 shares authorized, 300,000 issued and outstanding and entitled to cast 4.4 votes per share for a total of 1,320,000 votes or 61% of the total votes at a shareholders meeting. All of the issued and outstanding preferred stock was (and still is) owned and held by Heizer. None of the common was or is owned by Heizer. Heizer also held the previously described warrants for 1,304,000 shares of common at $3.60 per share and IDC's notes for $2,200,000.

In the fall of 1971, IDC required still additional cash to finance the continued operation of its monitoring business. It approached Heizer for an additional investment. On November 12, 1971, Dekraker resigned as a director of IDC as did Johnston on November 16, 1971. As a consequence, on November 19, 1971, when IDC and Heizer entered into an agreement which became the fourth transaction, the IDC board consisted of Ross, its chief executive officer, Loew, representing Beneficial Standard Corporation, Heizer and Palmer, representing Heizer, and Labow, an independent director.

The fourth transaction agreement provided for loans up to $600,000 by Heizer to IDC evidenced by IDC's note payable on demand after March 31, 1972. In the event Heizer loaned the entire $600,000 and the note was not timely paid, it would

become convertible into common stock of IDC at $1.00 per share. In the event the note became convertible, the price provisions of the three warrants previously issued to Heizer would again be adjusted so as to decrease the warrant exercise price from $3.60 per share to $1.00 per share and increase the number of common shares purchasable under those warrants from 1,304,000 to 4,694,400 shares.

The documents comprising the fourth transaction were presented to a meeting of the IDC board held on November 19. Only Ross, Labow, Heizer and Palmer were present. They voted unanimously to approve the fourth transaction. Heizer and Palmer deferred their votes until Ross and Labow voted on the proposal. But the votes of Heizer and Palmer were essential to approval. The board also resolved to recommend to the stockholders the adoption of an amendment to IDC's certificate of incorporation increasing the number of authorized common shares from 3,000,000 to 7,000,000. And they directed that in lieu of a stockholders meeting, written consents to the amendment be obtained as permitted under the Delaware corporation law.

The consents of 52.4% of IDC's common shareholders and 100% of the preferred shareholders (i.e., Heizer), were obtained to the amendment to the certificate of incorporation increasing the number of authorized common shares from 3,000,000 to 7,000,000. Thereafter and pursuant to the terms of the fourth transaction, Heizer loaned IDC $600,000. At the time the loan was funded there was virtually no chance that IDC could repay it by its due date, March 31, 1972.

On March 13, 1972 a meeting of IDC's board of directors was held at which all five of the incumbent directors were present either in person or by telephone. At that meeting, by a vote of 4 to 1 the directors authorized an amendment to the November 19, 1971 agreement providing for an additional loan from Heizer to IDC of an amount up to $250,000. Ross, Labow, Heizer and Palmer voted in favor, Loew, representing plaintiff

Beneficial, voted against. The new loan was to be governed by all of the terms of the November 19 agreement. On March 13 Heizer loaned IDC an additional $105,000 pursuant to the amendment. In addition, fees due from IDC to Heizer for management services performed by Heizer under the earlier agreements were accrued and deemed to have been loaned to IDC under the terms of the November 19 agreement, if not paid on March 31, 1972. They were not and IDC issued a convertible demand note in the amount of $114,508 to cover them.

IDC was unable to repay any of the loans or fees pursuant to the fourth transaction by March 31, 1972. As a consequence, all of the fourth transaction notes held by Heizer became convertible into IDC common stock at $1.00 per share, and as a consequence of that, the previously issued warrants held by Heizer became operative at the decreased exercise price of $1.00 per share so as to increase the number of shares purchasable by Heizer to 5,513,000 shares of IDC common representing approximately 87% of IDC pro forma common stock equity.

To date Heizer has not exercised any warrants or other rights to purchase IDC common stock. Plaintiffs seek to enjoin that exercise and obtain a rescission of the first, second, third and fourth transactions.

At the annual meeting of IDC stockholders held May 25, 1972, the following persons were elected directors of IDC: Jordan Ross, chairman of the board and chief executive officer; Marcus Loew II representing Beneficial Standard Corp.; Edgar F. Heizer, Jr., representing Heizer; Powers Cameron, vice president, Heizer Corporation, representing Heizer; and George Sneed, representing Heizer. On June 21, 1972, Loew resigned.

At a meeting of IDC's board of directors held June 29, 1972, attended by Heizer, Cameron and Sneed, Paul M. Roth was elected president and a director of IDC. On November 20, 1972, Sneed resigned from the board.

On October 11, 1972, this action was commenced.

On June 8, 1973, the board of directors of IDC consisted of Heizer, Cameron, Roth and Ross. On that date IDC required still additional cash to continue the operation of its monitoring business. Accordingly, the board approved a pledge agreement between IDC and Heizer by a vote of 3 to 1, Roth, Heizer and Cameron voting "yes" and Ross "no". Again the votes of Heizer and Cameron were essential to approval. The pledge agreement provided that Heizer would refrain, until January 2, 1974, from making demand for payment of the demand notes totalling $819,508, issued to it by IDC pursuant to the fourth transaction. It also covered some additional non-convertible demand notes which had been issued to Heizer by IDC between April 14, 1972 and April 19, 1973, in the amount of $2,015,000. The agreement further provided that Heizer would make additional demand loans to IDC during the balance of 1973 in the maximum amount of $1,181,700, and the minimum of $460,400, and that Heizer would refrain from making demand for repayment of those additional loans until January 2, 1974. Pursuant to the agreement, IDC pledged all of the stock of its wholly owned and profitable subsidiary, Talent and Residuals, Inc., to Heizer as security for repayment of all loans made by Heizer to IDC on a non-convertible demand note basis since April 14, 1972, as well as the new loans made pursuant to the pledge agreement. Upon consummation of the agreement, the TR stock was delivered by IDC to Heizer.

By an amended complaint, plaintiffs challenge the fifth or pledge transaction.

Plaintiffs Maintenance of the Action as Shareholders of IDC

Plaintiffs assert that, as minority common shareholders in IDC, they may maintain this action challenging the foregoing IDC-Heizer securities transactions either derivatively in behalf of IDC, the issuer-seller of the securities, or individually and as

representatives of a class of common shareholders who are investors in IDC. They agree that their alternative "investor" theory is bottomed upon *Eason* v. *General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). They concede, as they must, that they did not directly sell or purchase the securities in question.

Substantively they allege that the entire series of transactions were tainted by conduct prohibited by Rule 10b-5. The full scope of their claimed violations of the Rule will be considered later; suffice it here to say that they assert that material facts concerning the first four transactions were concealed from the shareholders of IDC and that Heizer aided and abetted in that concealment; that in the course of the transactions, Heizer assumed the position of a controlling person or shareholder and owed a fiduciary duty of disclosure to the minority shareholders, which it breached; that Heizer, through the directors it elected to the IDC board of directors engaged in fraudulent self dealing in respect to the fourth and fifth or pledge transactions; and that the fifth or pledge transaction entered into as it was subsequent to plaintiffs' challenge here of the first four, was a maneuver patently calculated to frustrate the effectiveness of any remedy which might be granted here in respect to the first four.

Heizer vigorously challenges plaintiffs' right to maintain the action in light of the Supreme Court's decision in *Blue Chip, supra*, and it denies with equal vigor any wrongdoing in connection with the sale to it of the subject securities. It does concede, however, that IDC was an issuer-seller of securities and that the conduct of which plaintiffs complain was in connection with the sales of those securities (including the notes and transfer of TR stock attendant the pledge) by IDC to Heizer.

The threshold question to be decided is whether plaintiffs as shareholders in IDC may maintain this action. We believe the answer is clearly that they may derivatively in behalf of IDC.

The history of the judicially created private action under Rule 10b-5 need not be retold here. It had its origin in *Kardon* v. *National Gypsum Co.*, 69 F.Supp. 512 (E.D.Pa. 1946). While judicial interpretations and applications of the substantive scope of the Rule's prohibitions have varied, they have steadily expanded to the end that in *Karvelas* v. *Sellas*, 376 F.Supp. 1010, 1012 (N.D.Ill. 1974), we observed, "The language of Rule 10b-5 interdicts any act or practice which operates as a fraud or deceit . . . in connection with the purchase or sale of a security." *See, also, Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971).

The concomitant question of who may complain of an alleged violation of the Rule's prohibitions has also been steadily answered, primarily as the result of the Second Circuit's pilot decision in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956. There one Feldman, a controlling shareholder of Newport, sold his stock at a premium after rejecting a highly profitable offer of merger which he did not communicate to the other shareholders. Plaintiffs, shareholders of Newport, brought an action on behalf of the corporation and all similarly situated shareholders alleging that the transaction operated as a fraud upon the shareholders in connection with the sale of Feldman's stock and that Rule 10b-5 was violated. The district court dismissed the action because the Rule was "aimed only at 'a fraud perpetrated upon the purchaser or seller' of securities and having no relation to breaches of fiduciary duty by corporate insiders resulting in fraud upon those who were not purchasers or sellers." *Id.* at 463. The court of appeals affirmed similarly concluding that the Rule was "directed solely at that type of manipulative or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and [the Rule] extended protection only to the defrauded purchaser or seller." *Id.* at 464.

Of course, *Birnbaum's* restrictive interpretation of the nature of the fraud prohibited by the Rule has been discarded. *Superintendent of Insurance* v. *Bankers Life and Casualty Co., supra; Dasho* v. *Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967), *cert. denied*, 389 U.S. 977 (1967). However, its conclusion that the Rule extends protection "only to a defrauded purchaser or seller" has survived. *But see, Eason* v. *General Motors Acceptance Corporation, supra; Karvelas* v. *Sellas, supra.*

In *Blue Chip Stamps* v. *Manor Drug Stores, supra,* the Supreme Court for the first time considered *Birnbaum's* purchaser-seller limitation. There plaintiffs were offerees of common shares in a new company organized by defendants under an anti-trust consent decree. Charging that defendants had devised a scheme to discourage plaintiffs from purchasing the shares by materially misleading statements containing an overly pessimistic appraisal of the new business so that the rejected shares might be offered to the public at a higher price, plaintiffs sued for money damages alleging a violation of Rule 10b-5. The district court, relying on *Birnbaum*, dismissed the action. The court of appeals reversed, holding that the particular facts of the case warranted an exception to the *Birnbaum* limitation. On certiorari the Supreme Court reversed. The Court traced the history and application of the *Birnbaum* dictum, noting without disapproval that shareholders have "frequently [been] able to circumvent the *Birnbaum* limitation through bringing a derivative action on behalf of the corporate issuer if the latter is itself a purchaser or seller of securities." As an example of that circumvention, the Court cited *Schoenbaum* v. *Firstbrook*, 405 F.2d 215, 219 (2d Cir. 1968), *cert. denied sub nom. Manley* v. *Schoenbaum*, 395 U.S. 906 (1969), in which the Second Circuit declined to apply its own *Birnbaum* limitation to a derivative action by the shareholders of a seller corporation who alleged 10b-5 fraud in the sale of the corporation's securities.

More significant, however, was the Court's citation of the Seventh Circuit's decision in *Dasho* v. *Susquehanna Corp.*,

supra, as an example of a reaffirmation by lower federal courts "that the plaintiff class for purposes of . . . Rule 10b-5 private damage action[s] is limited to purchasers and sellers of securities." 421 U.S. at 731-32. *Dasho* was a derivative action brought by shareholders of Susquehanna who alleged that the corporation had been defrauded by its directors in both the purchase of its own stock and the sale of stock it owned in another corporation. While the opinion of the court in *Dasho*, which was written by Judge Schnackenberg, made no mention of the *Birnbaum* limitation, a tightly reasoned concurrence by now Chief Judge Fairchild, joined in by Judge Cummings, expressly confronted the limitation and rejected it because derivatively "the corporation is here suing as a defrauded seller and buyer of securities." 380 F.2d at 270.

Thus, we conclude that the purchaser-seller limitation as examined and rearticulated in *Blue Chip* does not preclude plaintiffs, as shareholders in IDC, from complaining derivatively of injuries to IDC occasioned by conduct prohibited by the Rule in connection with IDC's sale of its securities to Heizer.

Plaintiff's efforts to maintain their claim as investors in IDC under *Eason* v. *General Motors Acceptance Corp., supra,* is a different matter.

At the outset we observe that plaintiffs' investor posture is redundant of their derivative stance to the extent that they complain of injuries inflicted on IDC. But to the extent that they complain of injury to themselves as investors—i.e., holders of securities which they have previously purchased—do they collide with the *Blue Chip* limitation? We believe the answer to this lies in a careful analysis of *Eason* upon which they rely and a further analysis of *Blue Chip* and its recognition and treatment of *Eason.*

In *Eason*, plaintiff, who incidentally was a shareholder in Bank Service, guaranteed obligations of Waite to GMAC when Waite sold its automobile leasing business to Bank Service in

exchange for Bank Service's assumption of Waite's primary liability to GMAC and shares of stock in Bank Service. The automobile leasing business failed, Bank Service went into bankruptcy and GMAC sued Eason on his guarantee. Eason responded with a 10b-5 action against GMAC and Waite in which he alleged that the underlying stock transaction between Bank Service and Waite was tainted by the fraud of both Waite and GMAC. As his guarantee was an integral part of the stock transaction, he sought rescission of the guarantee eschewing rescission of the sale of stock because Bank Service was bankrupt.

The district court dismissed Eason's complaint on the authority of *Birnbaum* because has was not the purchaser or seller of the subject securities. On appeal, the Seventh Circuit Court of Appeals reversed holding that the alleged fraud had been practiced in connection with the sale of Bank Service's stock to Waite and that Eason was a person entitled to the protection of Rule 10b-5 as an investor in Bank Service.

The court of appeals placed particular reliance on the Supreme Court's statements in *Superintendent of Insurance* v. *Bankers Life and Casualty Co., supra,* that Manhattan Casualty Co. (of which the Superintendent was liquidator) "was injured as an investor" and "suffered injury as a result of deceptive practices touching its sale of securities as an investor." 404 U.S. at 10, 12-13. And it concluded that the Court had "repudiated" *Birnbaum* in *Bankers Life*. 490 F.2d at 661.

The court of appeals' ultimate conclusion that *Birnbaum* had been repudiated by the Supreme Court in *Bankers Life* was questionable in view of the fact that Manhattan was clearly a defrauded seller of a security. But in any event, that conclusion cannot withstand the light of *Blue Chip:*

> . . . we are of the opinion that *Birnbaum* was rightly decided. . . .
>
> * * * * *
>
> Available evidence from the texts of the 1933 and 1934 Acts as to the congressional scheme in this regard, though not conclusive, supports the result reached by the *Birnbaum* court. . . .
>
> * * * * *
>
> The *Birnbaum* rule, on the other hand, permits exclusion prior to trial of those plaintiffs who were not themselves purchasers or sellers of the stock in question. . . .
>
> * * * * *
>
> The virtue of the *Birnbaum* rule, simply stated, in this situation, is that it limits the class of plaintiffs to those who have at least dealt in the security to which the prospectus, representation, or omission relates. . . .

421 U.S. 731, 733, 742, 747.

But, plaintiffs argue, Eason expressly survived *Blue Chip* by reason of the Court's treatment of it which is found in two places in the opinion. First, in support of it in an earlier quoted passage that federal courts have "reaffirmed *Birnbaum's* conclusion" the Court cited: "Compare *Eason* v. *General Motors Acceptance Corp.*, 490 F.2d 654 (CA7 1973), *cert. denied,* 416 U.S. 960 (1974), with *Dasho* v. *Susquehanna Corp.*, 380 F.2d 262 (CA7), *cert. denied sub nom. Bard* v. *Dasho,* 389 U.S. 977 (1967)." 421 U.S. at 732. Plaintiffs urge that *A Uniform System of Citation* (1967), p. 87, states that "compare . . . with" is used when "the authorities cited, taken together, offer *some support* for statement in text." (Our emphasis.) But *Eason* in tandem with *Dasho* does "offer some support" for the Court's statement. As we have seen, *Dasho* was a derivative suit in behalf of a seller in which *Birnbaum* was embraced. *Eason* was a challenge to a guarantee which was an integral part of a tripartite security transaction. And while the court of appeals rejected the contention that Eason was a seller of either his guarantee or Bank Service's stock or a forced purchaser of the Waite notes held by GMAC, that does not mean that the Supreme Court, in appraising *Eason* approved the investor analysis which the court of appeals adopted. Indeed, as we have noted, while Eason's role as an investor undoubtedly motivated him to give

his guarantee, it was quite incidental to the undertaking he sought to avoid.

Furthermore, the Supreme Court's second treatment of *Eason* certainly cannot be stretched to read approval. Having acknowledged the court of appeals' statement that the risk of expanded litigation is not a "reason [to] reject what we believe to be a correct interpretation of the statute or the rule" (490 F.2d at 660) the Court said:

> But . . . we are not dealing here with any private right created by the express language of § 10b or of Rule 10b-5. . . . However, flexibly we may construe the language of both provisions, nothing in such construction militates against the *Birnbaum* rule. We are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question. . . .

421 U.S.

With some regret (*see, Karvelas* v. *Sellas, supra*), we conclude that the *Eason* investor rationale was not approved by *Blue Chip*.

There are other ramifications of *Blue Chip* which require attention, however, before we conclude that plaintiffs may not complain as injured shareholders under the facts presented here.

The Supreme Court carefully delineated the issue there presented: ". . . what limitations there are on the class of plaintiffs who may maintain a private cause of action for *money damages* for violation of Rule 10b-5. . . ." (421 U.S. 727. Emphasis supplied). And it took care to note that its "decision in *SEC* v. *National Securities, Inc.*, 393 U.S. 453 (1969), established that the purchaser-seller rule imposes no limitation on the standing of the SEC to bring actions for *injunctive* relief under § 10(b) and 10b-5." (421 U.S. 751, n. 14. Emphasis supplied.) Furthermore, it is fair to say that the policy arguments mustered by the Court in support of its approval of *Birnbaum* were keyed to its apprehensions of "strike" or *in terrorem* actions for money dam-

ages brought by owners of stock who do not sell or offerees who do not purchase allegedly because of overly optimistic or pessimistic representations regarding the future of the business in question. In short, it is clear to us that in *Blue Chip* the Court was concerned with the prospects of money damage litigation concerning securities transactions which had not occurred.

And so, what of shareholders, such as plaintiffs here, who rather than seeking money damages for the wrong allegedly done them by the fraudulent issuance and sale or threatened issuance and sale of additional securities, seek merely to undo or restrain the wrong? Should they likewise be barred by the purchaser-seller limitation? In this regard, we note that at no point in *Blue Chip* did the Court cite, let alone discuss or disapprove a cluster of courts of appeals decisions which appear to have declined to apply the strictures of *Birnbaum* to private 10b-5 actions seeking solely equitable relief. *See Mutual Shares Corp.* v. *Genesco, Inc.*, 384 F.2d 540, 546-47 (2d Cir. 1967); *Vincent* v. *Moench*, 473 F.2d 430, 434-35 (10th Cir. 1973); *Kahan* v. *Rosensteil*, 424 F.2d 161, 173 (3d Cir. 1970); *but see, Greater Iowa Corp.* v. *McLendon*, 378 F.2d 783, 791 (8th Cir. 1967).

We are tempted by the lure that *Blue Chip* should be confined to its facts and the relief there sought. But we must be mindful of the Court's function in hearing and deciding such cases. It does not sit to adjudicate individual disputes; that is the business of the district courts and courts of appeal. Rather, it uses individual cases and controversies to shape and guide the development of the law. This is particularly true where, as here, it speaks in an area of judge made law.

Thus, we have concluded that we would not be justified in drawing a distinction here between an action at law and one in equity. Compare Rule 2, *Fed. R. Civ. P.* And although the elements of uncertainty present in *Blue Chip* are not present here, we should apply its limitations upon the class of persons entitled to maintain any action under Rule 10b-5. Indeed, the Court

recognized that consequence when it said that the "three principal classes of potential plaintiffs . . . barred by the *Birnbaum* rule . . . [include] shareholders, creditors and perhaps others related to an issuer who suffer loss in the value of their investment due to corporate or insider activities in connection with the purchase or sale of securities which violate Rule 10b-5." 421 U.S. 737, 738. Nor does its previously noted tacit approval of a shareholder derivative action on behalf of a corporate issuer-seller mean that shareholders such as plaintiffs can be heard to complain in their own behalf. Accordingly, to the extent that plaintiffs' complaint is dependent on their status as investors in IDC, it will be dismissed.[3]

The Merits of Plaintiffs' Complaint

Plaintiffs' second amended complaint and their pre-and post-trial briefs are limited to a single theory of recovery: that the previously described securities transactions were tainted by fraud either practiced or aided and abetted by Heizer in violation of Section 10(b) of the Securities Exchange Act of 1934[4] and Rule 10b-5 of the Securities and Exchange Commission.[5] No

3. This conclusion renders moot plaintiffs' motion to certify a class of shareholders of IDC.

4. Section 10(b) provides in material part:

> It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. § 78j(b).

5. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate, or of the mails, or of any facility of any national securities exchange:
>
> (a) To employ any device, scheme, or artifice to defraud,

(Footnote continued on next page.)

other theory of relief has been urged. In these circumstances, our conclusion that plaintiffs can maintain their action only as a derivative one in behalf of IDC necessarily limits the scope of our inquiry as to whether IDC was victimized by Heizer's alleged misconduct.

The genius of 10b-5 lies in its breadth. It prohibits "any device, scheme or artifice to defraud" and "any act, practice or course of business which operates or would operate as a fraud or deceit. . . ." It prohibits "all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws." *A. J. Brod & Co.* v. *Perlow*, 375 F.2d 393, 397 (2d Cir. 1967). Despite *Birnbaum's* early conclusion that the Rule was not aimed at "fraudulent mismanagement of corporate affairs" (193 F.2d at 464), we know today that a breach of trust by corporate fiduciaries clearly falls within its ambit. *Superintendent of Insurance* v. *Bankers Life and Casualty Co., supra; Dasho* v. *Susquehanna Corp., supra,* and *Dasho* v. *Susquehanna Corp.*, 461 F.2d 11 (7th Cir. 1972); *Schoenbaum* v. *Firstbrook, supra.*

But the breadth of the Rule's prohibitions does not permit its application to transactions in connection with which there has been no fraud practiced upon the person enjoying the protection of the Rule. Here that person is IDC.

When we examine plaintiffs' proof in respect to the first three transactions we find it wanting. IDC was in need of cash

(Footnote continued from preceding page.)

> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

which Heizer was willing to provide. Heizer drove a hard bargain, particularly in respect to the third transaction. But nothing was concealed from IDC's directors, who were independent of Heizer, although subject to its weighted preferred shares vote following the second transaction. Nor was anything concealed from IDC's independent and able counsel. For all that appears here the first three transactions were open and at arms length vis-a-vis Heizer and IDC.

Plaintiffs' primary complaint in regard to the first three transactions is that their terms and the consequence thereof were concealed from IDC's common stockholders. And this is particularly true, they assert, in respect to the fact that the anti-dilution clauses in the warrants would be triggered not only by sales of common stock to outsiders but also by sales of common stock to Heizer under the terms of the later warrants which were issued at successively lower prices. Heizer, say plaintiffs, through its orchestrating officers and counsel, aided and abetted that concealment. Alternatively they urge that Heizer itself owed a duty of disclosure to the stockholders because it had assumed control of IDC through the continuation of business provisions of the agreements, its weighted preferred shares votes and the anti-dilution clauses which discouraged other investors and rendered IDC a captive investee.

This theory of fraud by concealment practiced on the shareholders is not available to plaintiffs under our interpretation and application of the *Blue Chip* limitation on the persons protected by Rule 10b-5. But if it were, the proof does not sustain the charge.

The terms and consequences of the first three transactions were not concealed from the stockholders. All of the stockholders meetings were held pursuant to notice. The notices and accompanying summaries described the business to be transacted at each meeting. The documents pertaining to the three transactions were made available to the shareholders prior to each meeting. The transactions were discussed at each meeting.

All three transactions were unanimously approved by the stockholders in attendance and voting. None of the transactions was challenged until this action was brought following the fourth transaction.

We find and conclude that the first three transactions were not tainted by any 10b-5 fraud of which plaintiffs can be heard to complain.

The fourth and fifth transactions are quite different. By the time they were entered into Heizer had put its agents on IDC's board and their votes were essential to the consummation of these transactions. Clearly, in these instances Heizer engaged in self dealing while occupying a fiduciary relationship to IDC. As such, if the transactions were not *per se* rescindable, at the very least Heizer had the heavy burden of proving their fairness. This it failed to do.

On the eve of the fourth transaction, Heizer held warrants to purchase 1,304,000 shares of IDC's common stock at $3.60 per share. By its additional investment of only $600,000, Heizer increased its claim on IDC's common equity to 4,694,000 shares at $1.00 per share and thereafter by additional demand loans which IDC had no likelihood of timely repaying to 5,513,000 shares at $1.00 per share.

Heizer's officers are experts at valuing corporations such as IDC. At the time of the fourth transaction, Heizer valued IDC common stock at $3.60 per share. This admission without more shows the gross inadequacy of the $1.00 per share price imposed upon IDC by the fourth transaction convertible note.

In addition, Heizer's audited statement for fiscal 1972, which was the year of the fourth transaction, confirmed that Heizer's valuation of IDC was the "fair value," and Edgar Heizer admitted that in November, 1971, when the fourth transaction was entered into, Heizer could have liquidated its investment in IDC at cost.

Heizer offered no evidence which discredited its valuation of IDC at $3.60 per share. Rather its witnesses testified that the

$1.00 per share price in the fourth transaction was the result of a formula designed to equate Heizer's pro forma equity to the percentage which its investment bore to IDC's total capital. Such an approach is hardly consistent with Heizer's obligation to deal fairly with IDC.

Insofar as the fifth or pledge transaction is concerned, Heizer's conduct was even more rapacious. In June, 1973 Heizer had the power through the warrants and convertible notes issued to it in the first four transactions, to capture 87% of IDC's equity and thereby capture the profitable TR. By then, plaintiffs had brought their action here challenging that threatened equity takeover. And so Heizer, by agreeing to refrain from demanding payment of the fourth transaction notes as well as some $2,000,000 which it had loaned IDC in the interim to keep the monitoring business afloat, took a pledge of all of the TR stock which Heizer's valuation committee had just valued at $8,000,000.

There was no evidence which even suggested that the pledge transaction was fair. Indeed, Heizer's witness Cameron admitted that IDC could not have repaid any of the notes secured by the pledge out of internally generated funds or any known outside financing source, and that the pledge was taken in order to protect Heizer from the outcome of this litigation which was pending in behalf of IDC. It is difficult to conjure a more blatant breach of trust. *Pepper* v. *Litton*, 308 U.S. 295 (1939); *Lebold* v. *Inland Steel Co.*, 125 F.2d 269 (7th Cir. 1941).

The Relief

District courts have the duty "to provide such remedies as are necessary to make effective the congressional purpose" in actions such as this. *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 433 (1964). The relief may include setting aside or enjoining the enforcement of rights purportedly created by the tainted transaction. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970).

Here plaintiffs seek only equitable relief by way of injunction, rescission and reformation. The rights of innocent parties have not intervened. Defendant Heizer has not exercised the warrants issued to it in the first three transactions or converted the note of the fourth. Nor has it foreclosed the pledge of the fifth transaction. Thus, there is no unscrambling to be done and we are not inhibited by any practical or countervailing equitable limitations which would militate against granting all of the relief warranted by our conclusion on the merits.

The primary thrust of the lawsuit has been directed at the increased claims upon IDC's equity which Heizer has acquired through the second, third and fourth transactions, and to safeguard IDC's stock ownership of TR. In view of the fact that we have found and concluded that only the fourth and fifth or pledge transactions are vulnerable to plaintiffs' challenge, the relief should be limited to those transactions.

The notes of the fourth transaction should be declared non-convertible and Heizer should be permanently enjoined from converting or attempting to convert any of those notes to shares of common stock of IDC. Any provision of the fourth transaction which authorizes or permits either directly or indirectly an increase in the number of shares of common stock of IDC issuable upon exercise of warrants held by Heizer under the first three transactions in excess of 1,304,000 shares, should be declared void. Similarly, any provision of the fourth agreement which authorizes or permits Heizer to exercise the previously issued warrants at a price of less than $3.60 per share, should be declared void and Heizer should be enjoined from seeking to enforce those provisions of the fourth transaction.

The stock pledge agreement of June 8, 1973, between Heizer and IDC should be cancelled and declared void and Heizer should be ordered to transfer to IDC all certificates representing shares of stock of TR held by Heizer pursuant to the stock pledge agreement. Heizer should also be ordered to release any and all

security interest in the shares of TR and it should be enjoined from enforcing in any way the stock pledge agreement.

In addition, because of the dominant position which Heizer holds in relation to IDC and its clear over-reaching manifested by the fourth and fifth or pledge transactions, Heizer should be enjoined from entering into any transaction with IDC except upon terms and conditions as shall be fair and equitable.

Plaintiffs' prayers for relief in respect to the first three transactions should be denied.

In view of the nature of these proceedings, the court will entertain an application by plaintiffs for an award of reasonable attorneys' fees.

Because a counterclaim remains pending, brought by IDC against plaintiffs, the court will direct the entry of judgment in accord with the foregoing, pursuant to Rule 54(b) of the Federal Rules of Civil Procedure. A decree to that effect has been entered this date.

ENTER:

/s/ Prentice H. Marshall
Judge Prentice H. Marshall

DATED: December 3, 1975.

DECREE OF DISTRICT COURT, DECEMBER 3, 1975

IN THE
UNITED STATES DISTRICT COURT
For the Northern District of Illinois
Eastern Division

PETER WRIGHT and BENEFICIAL STANDARD CORPORATION,
Plaintiffs,

vs.

THE HEIZER CORPORATION and INTERNATIONAL DIGISONICS CORPORATION,
Defendants.

No. 72 C 2536

DECREE

In accord with the memorandum decision herein which will stand as findings of fact and conclusions of law under Rule 52(a) of the Federal Rules of Civil Procedure,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED:

1. Any and all notes issued by International Digisonics Corporation [now known as IDC Services, Inc. (IDC)] to Heizer Corporation, and any and all loans made by Heizer to IDC, under or pursuant to that certain Loan Agreement between said parties, dated November 19, 1971, and any amendment thereof or supplement thereto, are hereby declared to be nonconvertible notes. Any provision contained in said Loan Agreement, or any amendment thereof or supplement thereto, which authorizes or permits, directly or indirectly, any loan made under or pursuant thereto, whether or not evidenced by a note, to be converted into any shares of common stock of IDC, is hereby declared to be

null and void and is now and shall hereafter be of no force or effect whatsoever. Heizer Corporation and IDC, and each of them, and their respective officers, directors, successors and assigns, are hereby permanently enjoined from converting or attempting to convert, directly or indirectly, any of said loans or notes into shares of common stock of IDC, and are further permanently enjoined from issuing or attempting to issue, directly or indirectly, any shares of common stock of IDC on account of or pursuant to any provision of said Loan Agreement, or any amendment thereof or supplement thereto.

2. Any and all warrants to puchase common stock of IDC, issued or issuable to Heizer Corporation or its nominees or assignees, by IDC, under or pursuant to the aforesaid Loan Agreement dated November 19, 1971, or any amendment thereof or supplement thereto, are hereby cancelled. Any provision contained in said Loan Agreement, or any amendment thereof or supplement thereto, which authorizes or permits, directly or indirectly, an increase in the number of shares of common stock of IDC issuable upon exercise of warrants held by Heizer Corporation, or any nominee or assignee thereof, in excess of 1,304,000 shares, is hereby declared to be null and void and is now and shall hereafter be of no force or effect whatsoever. Any provision contained in said Loan Agreement, or any amendment thereof or supplement thereto, which authorizes or permits Heizer Corporation, or any nominee or assignee thereof, to exercise warrants to purchase shares of common stock of IDC at an exercise price of less than $3.60 per share, is hereby declared to be null and void, and is now and shall hereafter be of no force or effect whatsoever. Heizer Corporation and IDC, and each of them, and their respective officers, directors, successors and assigns, are hereby permanently enjoined from:

(a) Exercising or attempting to exercise, directly or indirectly, any warrants to purchase shares of common stock of IDC, at an exercise price of less than $3.60 per share; and

(b) Issuing or attempting to issue, directly or indirectly, any shares of common stock of IDC at a price of less than $3.60 per share upon the exercise of any warrants held by Heizer Corporation, or any nominee or assignee threeof, to purchase shares of common stock of IDC.

3. In any transaction, direct or indirect, between Heizer Corporation, its nominee or assignee, and IDC, from and after the date hereof, no provision contained in any agreement between Heizer Corporation and IDC heretofore entered into which authorizes or permits an adjustment in the purchase price or number of shares issuable upon exercise of any outstanding warrants to purchase IDC common stock, shall be of any force or effect, and Heizer Corporation, its nominees and assigns, are hereby permanently enjoined from enforcing or attempting to enforce any such provision. Nothing herein contained shall prohibit Heizer Corporation from otherwise purchasing securities from or lending money to IDC under such terms and conditions as shall be fair and equitable.

4. The Stock Pledge Agreement dated June 8, 1973, between Heizer Corporation and IDC is hereby cancelled and declared null and void and of no force and effect whatsoever. Heizer Corporation is hereby ordered and directed forthwith to assign, transfer, convey and deliver to IDC all certificates representing shares of stock of Talent & Residuals, Inc., now held by Heizer Corporation under or pursuant to the aforesaid Stock Pledge Agreement. Heizer Corporation is further ordered and directed forthwith to release and cause to be cancelled any and all security interest in and to said shares of stock of Talent & Residuals, Inc. which Heizer Corporation has or may have acquired, perfected, filed or otherwise placed of record, and forthwith to deliver to IDC, with copy to counsel for plaintiffs, evidence of such release and cancellation. Heizer Corporation and IDC, and their respective officers, directors, successors and assigns, are hereby permanently enjoined from performing or enforcing performance of any provision of the aforesaid Stock Pledge Agree-

ment under which Heizer Corporation has or may have any rights in, to or against either the common stock of Talent & Residuals, Inc. or IDC itself.

5. Heizer Corporation, and its successors and assigns, are hereby permanently enjoined form entering, directly or indirectly, into any transaction with IDC except upon such terms and conditions as shall be fair and equitable.

6. With respect to warrants issued by IDC to Heizer Corporation pursuant to the agreements entered into between said parties on September 1, 1970 and May 11, 1971, plaintiffs' prayer for cancellation of the increase in the number of shares issuable and the decrease in the exercise price under said warrants, and for injunctive relief with respect thereto, are hereby denied.

7. Plaintiffs' prayers for cancellation of Article Fourth I, 4(A) of the Amendment to the Certificate of Incorporation of IDC, dated May 11, 1971, increasing the votes to which the holders of preferred stock of IDC are entitled from one vote for each share to 4.4 votes for each share, and for injunctive relief with respect thereto, are hereby denied.

8. Plaintiffs will be awarded reasonable attorneys' fees upon their application.

9. Pursuant to Rule 54(b) of the Federal Rules of Civil Procedure, the Court expressly determines that there is no just reason for delay and directs entry of judgment as hereinabove set forth.

ENTER:

/s/ Prentice H. Marshall
Judge Prentice H. Marshall

DATED: December 3, 1975.

OPINION OF THE DISTRICT COURT, MAY 28, 1976
(AS AMENDED JULY 2, 1976)

IN THE
UNITED STATES DISTRICT COURT
For the Northern District of Illinois
Eastern Division

PETER WRIGHT and BENEFICIAL STANDARD CORPORATION, *Plaintiffs,* *vs.* THE HEIZER CORPORATION and INTERNATIONAL DIGISONICS CORPORATION, *Defendants.*	No. 72 C 2536

MEMORANDUM DECISION

Cross appeals were taken from our decision and decree of December 3, 1975, *Wright* v. *Heizer Corporation,* ..... F. Supp. ..... (N.D.Ill. 1975), which were entered pursuant to Rule 54(b), *Fed. R. Civ. P.* Upon docketing in the Court of Appeals, plaintiffs sought and obtained an order of remand "for the limited purpose of permitting the district court to consider those issues [still] pending before it. . . ." Order Feb. 23, 1976. There were then pending here defendant IDC's motion for summary judgment on Count III of plaintiffs' amended complaint (which had not been but now is fully briefed) and plaintiffs' motion for attorneys' fees. Thereafter plaintiffs renewed a petition for supplemental and preliminary relief which they had presented (and which was continued by agreement) while Counts I and II of their amended complaint were under advisement

following the trial of those counts on the merits. That renewed petition was followed by plaintiffs' motion for the appointment of a receiver for defendant IDC. And, most recently, plaintiffs have presented a new motion for a preliminary injunction in respect to a proposed recapitalization of IDC. We dispose of these pending matters seriatim.

IDC's motion for summary judgment on Count III

While Counts I and II of plaintiffs' amended complaint were brought derivatively in behalf of IDC and representatively in behalf of its common shareholders, Count III is an action by Beneficial Standard Corporation (BFC) against IDC for alleged violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5 thereunder, in connection with the conversion of a $425,000 IDC convertible debenture held by BFC into common stock of IDC.

BFC acquired the debenture on January 10, 1969. By its terms it was "mandatory" that the debenture be converted to common stock "on or before the filing by [IDC] of the necessary documents and an 'S-1' Statement with the Securities and Exchange Commission which sets forth that [IDC] earnestly desires and seeks to make a public offering of its common stock in a minimum amount of Two Million Dollars. . . ."

BFC alleges that in June 1969 IDC falsely represented that it had entered into a firm underwriting agreement for the public distribution of 200,000 shares of IDC common at $10 or more per share and that a registration statement would be filed, all to the end that BFC voluntarily converted its debenture into common stock. BFC's original complaint, which was filed October 11, 1972, alleged that it had learned of the falsity of IDC's representations on October 1, 1969. Furthermore, IDC did file a registration statement for more than $2,000,000 of common stock on July 23, 1969. On these facts IDC asserts that it is entitled to summary judgment because BFC's fraud claim is time

barred and alternatively, assuming *arguendo* that IDC made the false representations ascribed to it in June 1969, the IDC registration statement of July 1969 mandated the conversion of BFC's debenture.

There is no general federal statute of limitations and no limitations provision in the federal securities laws applicable to BFC's claim. Therefore, the appropriate limitations statute of the state of the forum controls. *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123, 125 (7th Cir. 1972); *Janigan* v. *Taylor*, 344 F.2d 781, 783 (1st Cir. 1965). In *Parrent* the Court of Appeals held that the three year limitation in the Illinois Securities Law (*Ill. Rev. Stat.* ch. 121½, § 137.13(D)) applies to actions under 10b-5. That section provides:

> No action shall be brought for relief under this Section or upon or because of any of the matters for which relief is granted by this Section after three years from the date of sale.

BFC's amended complaint asserts that it converted its debenture into common stock on July 8, 1969. It had three years to sue from the date of conversion. *Silverman* v. *Chicago Ramada Inn*, 63 Ill.App.2d 96, 211 N.E.2d 596 (1965). This action was not commenced until October 11, 1972, more than three years from the date of the conversion.

BFC has asserted, however, that it did not learn of the alleged misrepresentations until October 1, 1969. Accepting that allegation as true, as we must, and applying the case law to the effect that the applicable statute of limitations in federal actions does not begin to run until the injured party discovers the alleged fraud, *Bailey* v. *Glover*, 21 Wall 342 (1875); *Janigan* v. *Taylor*, 344 F.2d 781 (1st Cir. 1965); *Morgan* v. *Koch*, 419 F.2d 993 (7th Cir. 1969), BFC's action is still time barred since it was filed more than three years from the date of discovery.

Finally, while BFC appears to allege subsequent factual misrepresentations by IDC there is no showing that it relied on

those supposed misrepresentations in postponing the filing of its suit. Absent such a showing, the statute of limitations is not tolled. *Dixon Mills, Inc.* v. *Dixon National Bank*, 357 F.2d 169 (7th Cir. 1966); *cf. Bergeron* v. *Mansour*, 153 F.2d 27 (1st Cir. 1945). And such a showing is in fact impossible here since plaintiff could hardly rely on a continuation of the same alleged misrepresentations which, from the allegations of its own complaint, it already believed to be false. *Melhorn* v. *AMREP Corp.*, 373 F. Supp. 1378 (M.D.Pa. 1974).

In any event, on July 23, 1969—almost three months before the commencement of this action—IDC did file a registration statement for more than the $2,000,000 of common stock specified in the mandatory conversion clause of the debenture. Upon the happening of that event BFC was obliged to convert. How, in these circumstances, its earlier conversion injured it escapes us and BFC has provided no elucidation on the subject. Instead it seeks to draw a distinction between its "voluntary" conversion in June 1969 as opposed to a "mandatory" conversion in 1969. The distinction escapes us insofar as any *injury* to BFC is concerned.

IDC's motion for summary judgment as to Count III of the amended complaint is granted and judgment will enter dismissing that count.

Plaintiffs' application for attorneys' fees

In our memorandum decision of December 3 we stated that we would entertain an application from plaintiffs for an award of reasonable attorneys' fees, which was promptly presented. In their application plaintiffs' counsel assert that the fees should be surcharged against the wrongdoing defendant Heizer Corporation rather than IDC and its shareholders who, according to plaintiffs, are the beneficiaries of plaintiffs' successful prosecution of this action. We note, without deciding, that there is substantial doubt as to the validity of plaintiffs' assertion that the fees when awarded should be surcharged against Heizer. See *Bailey* v.

Meister Brau, Inc., 74-1695, sl. op. 20-24 (7th Cir. May 6, 1976). In any event, the benefits of plaintiffs' success have not been finally adjudicated. Plaintiffs first appealed from the December 3 decree; Heizer cross appealed. The fees are "contingent upon the exigencies of equitable litigation, the final disposition of which in its entire process including appeal places such a claim in much better perspective than it would [be] at [this] stage." *Sprague* v. *Ticonic National Bank*, 307 U. S. 161, 168 (1939). Accordingly, we will defer hearing and ruling upon the fee application until the Court of Appeals has ruled.

Plaintiffs' petition for supplemental relief

On May 5, 1975, while the merits of Counts I and II were under advisement, plaintiffs petitioned for supplemental and preliminary injunctive relief respecting the debt obligations of IDC to Heizer arising out of the fourth and fifth transactions. In essence, plaintiffs sought an injunction which would restrain Heizer from enforcing those obligations *pendente lite*. The petition was continued on Heizer's assurance that it would not enforce the obligations until the merits of Counts I and II were decided. The decree of December 3, 1975 was a final one in respect to Counts I and II. It granted substantial relief to IDC at plaintiffs' derivative behest in respect to the fourth and fifth transactions. It did not, however, specifically enjoin the collection of the debt obligations or subordinate them.

On January 6, 1976, more than 10 days after the entry of the December 3, 1975 decree, plaintiffs renewed their May 5, 1975 petition for supplemental relief. In these circumstances, we hold that the May 5, 1975 petition for supplemental and preliminary relief was mooted by or merged into the December 3 decree and the renewed petition was an untimely effort to modify the decree. Rule 59(e), *Fed. R. Civ. P.* Accordingly, we deny plaintiffs' May 5, 1975 petition for supplemental and preliminary relief and their January 6, 1976 renewal thereof.

Plaintiffs' petition for appointment of receiver

Since the limited remand from the Court of Appeals, plaintiffs have presented a petition for the appointment of a receiver for IDC upon the grounds that it has not joined forces with plaintiffs in defending the cross appeal taken by Heizer Corporation following plaintiffs' perfection of their appeal from the December 3 decree and it has not joined forces with plaintiffs in seeking to surcharge Heizer with plaintiffs' attorneys' fees, and because during the trial of 1974 there was testimony that a former member or associate of the law firm of Sidley and Austin (which now represents IDC) had once represented some of the investors in Heizer Corporation.

None of the allegations warrant the extraordinary relief plaintiffs seek. A decree has been entered which, if affirmed, will be enforced. Plaintiffs obtained that decree but they are dissatisfied with it and have appealed seeking more extensive relief than was granted here. Heizer has cross appealed. IDC, through its independent counsel, has played a bystander role in this litigation to date, save for Count III in which it was sued directly by BFC. There is no reason why it should not continue to do so.

Insofar as plaintiffs' attorneys' fees are concerned, they will await another day.

The possible conflict of interest said to exist from the alleged representation of Heizer investors by a former partner or associate of Sidley and Austin, has been gleaned by plaintiffs from testimony given two years ago. The case has been fully adjudicated without any suggestion that IDC's counsel were disqualified from representing their client. Cf. *Cannon* v. *U. S. Acoustics Corp.*, 398 F.Supp. 209 (N.D.Ill. 1975), aff'd in part, 75-1810 (7th Cir. Mar. 31, 1976). We decline to entertain such a suggestion now under the guise of a petition to appoint a receiver.

The petition to appoint a receiver for IDC is denied.

Plaintiffs' current motion for a preliminary injunction

On May 20, 1976 plaintiffs presented yet another motion for a preliminary injunction in respect to a plan of recapitalization of IDC which has been proposed by Heizer Corporation to be voted upon at the annual meeting of the stockholders of IDC to be held June 2, 1976. Under the plan Heizer will, *inter alia*, exchange $6,000,000 of its IDC debt obligations for an equal amount of a new IDC Class A Non-voting Preferred Stock. Plaintiffs assert that until we have ruled on their petition for supplemental relief (which we have now done) Heizer should not be permitted to convert its IDC debt obligations to equity. Accordingly they seek to enjoin the stockholders meeting.

Clearly plaintiffs' instant motion is made in aid of their petition for supplemental relief which has now been denied. Accordingly, the motion to enjoin the shareholders meeting is likewise denied. In so ruling, however, we express no opinion as to the merits of Heizer Corporation's plan of recapitalization nor do we express any opinion as to whether it is consonant with the decree entered herein on December 3, 1975.

Orders in accord with the foregoing will enter.

ENTER:

/s/ PRENTICE H. MARSHALL
Judge Prentice H. Marshall

Dated: May 28, 1976.

INJUNCTION ENTERED BY DISTRICT COURT, JUNE 18, 1976

IN THE UNITED STATES DISTRICT COURT
For the Northern District of Illinois
Eastern Division

PETER WRIGHT and BENEFICIAL STANDARD CORPORATION,
Plaintiffs,

vs.

THE HEIZER CORPORATION and INTERNATIONAL DIGISONICS CORPORATION,
Defendants.

No. 72 C 2536

INJUNCTION PENDING APPEAL

On motion of plaintiffs, and for the reasons set forth this day in the oral opinion delivered by this Court, which oral opinion includes the Court's findings of fact and conclusions of law;

IT IS HEREBY ORDERED:

1. Heizer Corporation and IDC Services, Inc. (successor in name to defendant International Digisonics Corporation), and each of them, are hereby enjoined, during the pendency of the appeals in this cause, from taking any steps to authorize, approve, effect, implement or consummate Heizer Corporation's proposed plan of recapitalization of IDC Services, Inc., tendered to the shareholders of IDC under date of May 12, 1976, including but not limited to the taking of any action respecting said plan at the adjourned meeting of shareholders of IDC on June 21, 1976.

2. Heizer Corporation and IDC Services, Inc., and each of them, are hereby enjoined, during the pendency of the appeals in this cause, from directly or indirectly enforcing or permitting payment of any of the demand notes issued by IDC and held by Heizer Corporation, or any interest thereon.

ENTER:

/s/ PRENTICE H. MARSHALL
United States District Judge

Dated: June 18, 1976

Supreme Court, U. S.
FILED
JAN 13 1978
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977.

No. 77-814

HEIZER CORPORATION,

Petitioner,

vs.

PETER WRIGHT, BENEFICIAL STANDARD CORPORATION AND IDC SERVICES, INC.,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI.

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Method of Citation.

Citations to the Petition are given as "Pet."; citations to the Appendix to the petition are given as "A" followed by the page number therein. Citations to plaintiffs' exhibits and defendant's exhibits are given as PX and DX, respectively, and citations to the trial record are given as "Trial Tr." followed by the page therein. Citations to papers other than the foregoing, included in the record on appeal are given as "R." followed by the index number of said paper.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-814.

HEIZER CORPORATION,

Petitioner,

vs.

PETER WRIGHT, BENEFICIAL STANDARD CORPORATION AND IDC SERVICES, INC.,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI.

Respondents pray that the Petition for Writ of Certiorari be denied.

QUESTIONS PRESENTED.

The questions which petitioner purports to present to this Court are nicely framed as important issues involved in the administration of the federal securities laws. (Pet. 2-3) But examination of petitioner's subsequent argument reveals that the only real questions presented are: (a) whether the evidence was sufficient to establish petitioner's liability for violations of Section 10(b) of the Securities Exchange Act of 1934; and

(b) whether the evidence supported the equitable relief granted below. This Court has heretofore condemned the practice of misstating the questions in such fashion. *Southern Power Company* v. *North Carolina Public Service Company*, 263 U. S. 508, 509 (1924).

Questions respecting the power of the courts below to fashion the relief granted (Pet. 3) were not raised below and may not be raised in the petition for the first time. *United States* v. *Ortiz*, 422 U. S. 891, 898 (1975); *Tacon* v. *Arizona*, 410 U. S. 351, 352 (1973); *Adickes* v. *Kress & Co.*, 398 U. S. 144, 147 n. 2 (1970).

Petitions such as the present one, which pay lip service to Rule 19 of this Court, but actually involve no more than evidentiary disputes, or matters raised for the first time in this Court, fly in the face of the stern admonition of this Court in *Southern Power, supra.*

ADDITIONAL STATEMENT OF THE CASE.

1. Introduction.

Petitioner's statement of the case is inaccurate in that it omits pertinent facts found by the courts below as well as facts undisputed in the record.

Petitioner presents a false picture of itself as a misguided but nevertheless honestly motivated investor in IDC. But the findings of four judges below, as well as the undisputed facts in the record, establish otherwise. As hereinafter shown, once petitioner gained control of IDC it proceeded to engage in a series of concealed, self-dealing transactions, intentionally structured to insure that it would capture substantially all of the profits if the business succeeded, but would suffer none of the losses if it failed.

These transactions were characterized by the District Court as "rapacious" and "more rapacious," and were condemned by the Seventh Circuit as a "heads-I-win-tails-you-lose series of transactions." (A30) A fair and complete statement of the case as set forth hereunder fully supports these assessments.

2. Nature of the Action.

Plaintiffs below (respondents here) are minority common stockholders of IDC Services, Inc. ("IDC")[1] suing derivatively. In their second amended complaint, brought under Section

1. In November, 1969, IDC had at least 35 stockholders holding an aggregate of 840,000 shares. Twenty-five stockholders bought their shares for cash at prices between 15¢ and $5.00 per share; the balance paid in services or by exchanging their stock of Talent & Residuals, Inc. for IDC stock. (PX 62, pp. 16-17) The same persons were shareholders in September, 1970, PX 9, and there is no evidence that this situation had changed any time during the period in suit. Respondent Wright paid $5.00 per share for his 2,500 shares; respondent Beneficial paid an average of $2.50 per share for its 170,000 shares. (PX 62, pp. 16-17)

10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b) and Rule 10b-5 thereunder, 17 C. F. R. § 240.10b-5, plaintiffs challenged a series of five securities transactions between IDC and defendant Heizer Corporation (petitioner here).

3. The First Three Transactions.

The first three transactions were found by the District Court to be free of any 10b-5 fraud. (A63)[2]

Each of these transactions was approved by IDC's common stockholders at a meeting called and held pursuant to notice. Documents pertaining to each of the transactions were made available to the common stockholders prior to each meeting. (A62)

In the first transaction, in November, 1969, petitioner acquired 100,000 shares of preferred stock of IDC at $10.00 per share, and warrants to purchase 155,000 shares of common stock at $8.50 per share, equivalent to approximately 15% of IDC's pro forma common stock equity. The warrant agreement contained an antidilution clause which would automatically adjust the price downward and the number of shares purchaseable upward if IDC later sold stock or rights to stock at a price lower than $8.50 per share.

In the second transaction, in September, 1970, petitioner acquired an additional 200,000 shares of preferred stock at $10.00 per share and a second warrant to purchase an additional 400,000 shares of common stock at $6.00 per share. The second warrant also contained a similar antidilution clause. Petitioner agreed not to enforce the antidilution clause in its first warrant. After the second transaction, petitioner held warrants to purchase 555,000 shares of IDC common, or approximately 40% of IDC's pro forma common stock equity.

In the third transaction, in May, 1971, petitioner loaned IDC $1,700,000 on a 20-year note and acquired a third warrant to

2. Respondents did not appeal from this ruling.

purchase 472,222 shares of common stock at $3.60 per share. The third warrant also contained a similar antidilution clause. The antidilution clauses in the earlier warrants were triggered, increasing the number of shares purchaseable thereunder and decreasing the purchase price thereof. As a result, at the end of the third transaction, petitioner held warrants to purchase 1,304,000 shares of IDC common stock at $3.60 per share, equivalent to 61% of IDC's pro forma equity.[3]

An additional feature of the third transaction was an amendment of IDC's certificate of incorporation increasing the voting rights of petitioner's preferred stock to 4.4 votes per share, giving petitioner 61% voting control over IDC. (A48)

While the District Court found that "the first three transactions were not tainted by any 10b-5 fraud . . ." (A63), in the next sentence it expressly stated: "The fourth and fifth transactions are quite different." (*Id.*)

4. The Fourth Transaction.

At the time of the fourth transaction petitioner admittedly was in control of IDC (Trial Tr. 688) and had two representatives on its five-man board of directors. (A18)

IDC was then experiencing financial difficulties because of losses in its television monitoring business; but it was not bankrupt.[4] The fair value of its common stock was $3.60 per share, as determined by petitioner's expert evaluation and as admitted by petitioner's president at trial. (A63; PX 48) At this

3. The precise number of shares purchaseable as a result of the triggering of the antidilution clauses in the earlier warrants was adjusted by negotiation and was not the result of a pure application of the formula. (A8 n. 6)

4. The testimony of petitioner's expert that IDC was bankrupt at the time of the fourth transaction (Pet. 9) was subjected to intense cross-examination (Trial Tr. 2244-84), and not found credible by the trial court. Otherwise, that court could not have found that the value of IDC's common stock at that time was $3.60 per share. (A63)

point petitioner valued IDC's wholly-owned subsidiary, Talent & Residuals, Inc. ("T&R), at $4.8 million, and valued IDC as a whole at $7.2 million (PX 48). Thus, immediately prior to the fourth transaction, petitioner's investment in IDC of $4.7 million was well secured.[5]

In the fourth transaction, pursuant to a loan agreement dated November 19, 1971, petitioner agreed to loan IDC $275,000 immediately and, *at petitioner's election,* to loan it an additional $325,000, or a total of $600,000. (PX 14) The loans were evidenced by notes payable on demand after March 31, 1972.[6] In addition, IDC was deemed to have borrowed all amounts due petitioner under a management agreement with petitioner, as well as interest accrued on the 20-year note issued in the third transaction. If all of these loans, aggregating $714,508 were not repaid, within a very short time, by March 31, 1972, then, pursuant to the agreement, the notes would become convertible into common stock of IDC at a price of $1.00 per share. (A48-49; PX 14) In the event the notes became convertible, the antidilution clauses in all of the earlier warrants would be triggered, as a result of which the total number of shares purchasable thereunder would increase from 1,304,000 to 4,694,000 and the purchase price would decrease from $3.60 to $1.00 per share. (A49; PX 14)

5. Petitioner's motivation in entering into the fourth transaction seems clear. If it had doubted the continued viability of IDC, it could have forced a liquidation and recaptured its investment intact. It did not, but chose to continue to finance IDC's monitoring business, although not compelled to do so, obviously with the expectation that it would become profitable and that the expected return would far exceed the risk, which was minimal. Indeed, 18 months later petitioner was advising its own stockholders that by 1979 it expected its then $7.5 million investment in IDC to be worth $50 million. (PX 69, p. 7) Alternatively, petitioner could have permitted IDC to terminate monitoring and to repay petitioner's $4.7 million out of T&R's fully tax-sheltered earnings which petitioner projected at $657,000 for 1972, $788,000 for 1973 and $946,000 for 1974. (PX 48)

6. The funds were actually advanced as follows: 11/15/71, $60,000; 11/19/71, $215,000; 12/17/71, $100,000; 1/10/72, $125,000; 3/1/72, $100,000. (PX 54)

The $1.00 per share conversion price had been fixed by petitioner, and, according to its president, had no relation to book value, earnings, market value or any other recognized valuation method. (Trial Tr. 190-192, 695-698) Petitioner admitted that it formulated the $1.00 price in order to trigger the antidilution clauses in petitioner's earlier IDC warrants, and thereby to equate its claim on IDC's common stock equity to the percentage which its total investment (both debt and preferred stock)[7] bore to IDC's total capital. (A64; Trial Tr. 701-02)

Petitioner's president also admitted that at the time of the fourth transaction, he knew there was virtually no chance that IDC could repay the loans made thereunder on their maturity date of March 31, 1972. (A49; Trial Tr. 710-711)

At the time of the fourth transaction petitioner was simultaneously negotiating with an independent investment banker, McCormick & Company, for a public offering of IDC securities, including warrants for IDC common stock at an exercise price of $4.00 per share. (DX 78; Trial Tr. 2054) As one of the conditions for petitioner's consent to the financing, it was to receive 100,000 of these $4.00 warrants. (DX 82)

An express condition of the fourth transaction was the amendment of IDC's certificate of incorporation to increase the number of authorized common shares from three million to seven million. (A49; PX 14) Without this amendment petitioner's scheme could not have worked. (A16n.10) For this reason, the Court of Appeals described this condition as a "critical element." (A16)

Because of IDC's need for funds, it was decided to obtain written consents to the amendment from a majority of IDC's common stockholders, in lieu of a meeting, as permitted by Delaware law. (A10) Petitioner delegated to its counsel responsibility for obtaining such consents. (Trial Tr. 738, 741-743)

7. Petitioner has never owned any IDC common stock. Its investments initially were and always remained in IDC senior securities.

At the time that the consents were obtained, the directors of IDC had not yet approved the transaction and drafting of the agreement had not yet been completed; no documents containing the terms of the agreement accompanied the bare consent forms. (Trial Tr. 1784, 1785) The consent form itself contained no information about the transaction. (PX 16)

Petitioner knew that its counsel was supervising and controlling communications to IDC shareholders, and that he had drafted the form of consent to be executed by the common stockholders. (A18) Petitioner knew that the necessary consents from the common stockholders would be obtained by Jordan Ross, one of IDC's directors (A10); that there was strenuous opposition to the transaction from respondent Beneficial Standard Corporation, IDC's largest independent shareholder after Ross (A25); and that numerous other independent shareholders would therefore have to be solicited (A10).

Ross was given no instructions on what he should tell the shareholders when he orally solicited their consents, nor was any inquiry made as to what he had said when he returned, approximately a day and a half later, with the signed consent forms. (A25-26)

The bare consent forms were executed by the holders of 437,250 shares of common stock or approximately 52% of the total outstanding. Of these, 283,800 were held by IDC directors (LeBow, 18,000 shares; Ross 265,800); and 5,000 shares were held by IDC's counsel. (PX 16) None of the other common stockholders who executed consents were given any explanation of the terms of the transaction or any documents reflecting such terms. (Trial Tr. 227-233; 350-352; 409) No evidence to the contrary was introduced at trial.

As previously noted, by the time that four of IDC's five directors,[9] including two representatives of petitioner, met to

9. Respondent Beneficial Standard Corporation's representative on IDC's board was not present; he was out of the country at the time. (A9) However, Beneficial Standard Corporation had previously registered its strong objections to the terms of the fourth transaction. (A25)

approve the fourth transaction on November 19, 1971, the consent of a majority of the common shareholders had already been obtained. (DX 93, pp. 2-3)[10] But at this time, IDC's bylaws did not permit corporate action by written consent of a majority of its shareholders. Thus, the first act taken at the November 19, 1971 board meeting was the amendment of IDC's bylaws to allow shareholder action by consent in lieu of a meeting. (*Id.*) The express reason for that amendment was to validate the consents to the fourth transaction which had previously been obtained. (*Id.*)

On March 13, 1972, pursuant to amendment to the fourth transaction agreement, petitioner loaned IDC an additional $105,000.[11] It was known to petitioner on that date that IDC would be unable to repay this loan on its maturity date, March 31, 1972 out of internally generated cash or any outside source of financing. (Trial Tr. 732)

On March 31, 1972, none of the loans made under the fourth transaction, or the amendment thereto, was paid by IDC. As a consequence, the notes evidencing said loans, now totaling $819,508, including $114,508 of accrued interest and management fees, became convertible into IDC common stock at $1.00 per share. Because of this the antidilution clauses in all of petitioner's earlier warrants were triggered, increasing the number of shares purchasable thereunder from 1,304,000 to 4,694,400, and reducing the purchase price from $3.60 to $1.00 per share.

Thus, as a result of the fourth transaction, for an additional investment of only $819,508 petitioner increased its claim on IDC's common equity to 5,513,908 shares (4,694,400 in warrants, plus 819,508 in convertible notes) or 87% at $1.00 per share. (A50, 63; R. 134, Stip. Nos. 42-45) Petitioner's president testified that he doubted "we" would have permitted an independent third party to invest in IDC on the same favorable

10. DX 93 is a verbatim transcript of a tape recording of the directors' meeting of November 19, 1971.

11. Respondent Beneficial Standard Corporation's representative on IDC's board voted against the additional loan. (A49-50)

terms which petitioner obtained in the fourth transaction. (Trial Tr. 888)

5. The Fifth Transaction.

At IDC's annual meeting of stockholders on May 25, 1972, petitioner elected a majority of IDC's directors. (A50) Thereafter, IDC, under petitioner's control, continued to borrow from petitioner on a demand note basis, to finance its monitoring business. By June, 1973, these demand loans aggregated $2 million. (PX 25, Sched. A) On October 11, 1972, respondents commenced this action in the District Court, challenging the first four transactions and petitioner's control of IDC. On June 8, 1973, petitioner's nominees on IDC's board caused IDC to pledge to petitioner all of the shares of IDC's wholly owned subsidiary, Talent & Residuals, Inc. ("T&R"). (A19)

The pledge secured the $2 million in demand loans and provided that petitioner would make additional demand loans to IDC during the balance of 1973 in a maximum amount of $1,181,700, and a minimum amount of $460,400. It further provided that petitioner would refrain from making demand for repayment of the prior loans as well as the additional loans for six months, until January 2, 1974. (PX 25)

Finally, the agreement provided that all of petitioner's obligations thereunder were terminable if IDC should commit an event of default under the agreement. Events of default were defined to include "default in the payment of or material nonperformance of any liability or obligation of IDC to H. C. [Heizer]." (PX 25, p. 6) In the event of such default the agreement expressly empowered petitioner to foreclose on the T & R stock "without notice or demand." (*Id.* at p. 5)

T&R's earnings before taxes had increased from $58,000 in 1968 to $523,000 in 1972. (PX 24, p. 21) By contrast, IDC's monitoring operations had never been profitable; from 1969 through 1972 it suffered aggregate losses of $5.7 million. (*Id.* at p. 18) At the time of the pledge T&R had been valued

at $7.5 million by an independent expert. (PX 24, p. 21) Petitioner itself valued T&R at $8 million. (A64; PX 50) Petitioner knew then that IDC could not repay any of the loans secured thereby on January 2, 1974 out of internally generated funds or from any known outside source of financing (A64; Trial Tr. 913-915, 1242-45)

Petitioner admitted that the pledge was unnecessary to secure repayment of its loans. (A23; Trial Tr. 933, 936-937) The real reason for the pledge was to protect petitioner against any adverse outcome of this litigation which was then pending (A24, A64) If respondents were successful in obtaining the relief sought, petitioner would lose control of IDC and would be locked into a senior position. (A24) Petitioner candidly admitted as much in its brief in the Court of Appeals. (Opening Brief of Heizer Corp., p. 49) The pledge was taken by petitioner to prevent this result. (A64)

No meeting of the common stockholders of IDC was held to consider the pledge. At no time prior to or after the pledge was disclosure of its terms made to the common stockholders of IDC, other than Jordan Ross, who voted against it at the director's meeting. All this was admitted by petitioner in its answer to the second amended complaint. (R. 63, Count II, ¶ 25)

IDC's common stockholders were first informed of the existence of the pledge by letter two months later. (PX 53, p. 5) The letter contained no disclosure:

a) of the true purpose of the pledge (*i.e.*, to insulate petitioner from the possible adverse outcome of the litigation);

b) of the total amount of indebtedness secured and to be secured by the pledge;

c) of the fact that there was no possibility of repayment of this indebtedness by January 2, 1974; or

d) of the value of the asset pledged. (*Id.*)

One month later respondents, having obtained a copy of the pledge through discovery, amended their complaint and sought rescission under Section 10(b).

6. The Petition for Supplemental Relief.

After trial, but before the District Court rendered its decision, respondents filed a petition for supplemental relief charging that, in a series of transactions after it gained control of IDC, petitioner imposed a total of $5 million in demand loans on the corporation to finance the monitoring venture at a time when it also held a claim on 87% of IDC's common stock equity. Respondents alleged that these note transactions were both a fraud on IDC and its common stockholders as well as a breach of petitioner's fiduciary duty, because, with its warrants and convertible notes, petitioner would reap substantially all of the profits, if the monitoring venture succeeded,[12] but if it failed, petitioner would use its notes to recapture its investment in full, thus shifting the entire burden of loss to IDC and its common stockholders. Respondents sought an offset of the amount of the monitoring losses against these notes. (R. 83) Subsequently, respondents urged, as an alternative ground, that the notes be transformed into common stock. (R. 101)

7. The Decisions of the Courts Below.

A. Liability.

In its Memorandum Opinion of December 3, 1975, the District Court did not in so many words address itself to the issues of nondisclosure or scienter in the fourth and fifth transactions. It chose to rest its finding of liability on petitioner's self-dealing and breach of fiduciary duty in the fourth and fifth transactions. (A63-64) However, immediately following its finding that the first three transactions were fully disclosed and free from fraud,

12. In 1973 petitioner had projected that by 1979 its investment in IDC would have a value of $50 million. (PX 69, p. 8)

it expressly stated that, "The fourth and fifth transactions were quite different." (A62-63) Further, it characterized petitioner's conduct in the fourth and fifth transactions as rapacious. (A64) The Court of Appeals did not disturb these findings.

In a subsequent opinion on May 28, 1976, the District Court denied respondents' petition for supplemental relief which had challenged the $5 million in demand loans.

After the District Court's decision in December, 1975, this Court decided *Ernst & Ernst* v. *Hochfelder*, 425 U. S. 185 (1976). Prior to oral argument in the Court of Appeals this Court decided *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U. S. 438 (1976). While the case was *sub judice* in that court, this court decided *Santa Fe Industries* v. *Green*, 430 U. S. 462 (1977). In its opinion the Court of Appeals expressly took note of these decisions and rejected the reasoning underlying the District Court's finding of liability. It then proceeded to review the record to determine whether, in the light of *Hochfelder*, *Northway* and *Green* the judgment of the District Court should be affirmed on grounds other than those relied upon by that court. (A15) After its review of the pertinent facts established at trial, none of which were in dispute, the Court of Appeals concluded that the evidence established the materiality, nondisclosure (A15-21), reliance and scienter (A21-27) necessary to affirm the judgment of the District Court on the issue of liability in the fourth and fifth transactions.

B. Relief.

In granting retrospective relief the District Court cancelled the conversion feature of the notes issued in the fourth transaction, as well as the additional warrants obtained by petitioner through the triggering of the antidilution clauses in the earlier warrants. It also voided the pledge agreement in the fifth transaction. (A64-68, 69-70) In substance, insofar as petitioner's claims on IDC's equity or liens on IDC's assets were concerned, the District Court returned petitioner to the position it was in prior to the fourth transaction.

In granting prospective relief the District Court enjoined petitioner from exercising any of its warrants in the future at a price of less than $3.60 per share (A68-69) In addition, in the light of petitioner's past conduct, it enjoined petitioner from entering into any future transactions with IDC except upon fair and equitable terms. (A66, 70)

While the case was on appeal, petitioner submitted a plan of recapitalization to IDC's common shareholders. Petitioner threatened to put IDC into bankruptcy if the common shareholders did not approve the plan. On June 18, 1976 the District Court entered an injunction pending appeal enjoining petitioner from consummating the plan and from collection of the demand notes. (A78-79)

The Court of Appeals affirmed the retrospective relief granted by the District Court. (A27-28) It reversed the prospective relief relating to the future exercise of any of petitioner's warrants at less than $3.60 per share. (A33-34) It modified the relief respecting future transactions between petitioner and IDC, deleting the District Court's broad equitable injunction and substituting a lesser form of relief governing such future transactions. (A32-33) It also affirmed the District Court's injunction pending appeal. (A30-31)

The Court of Appeals also reversed the District Court's dismissal of respondents' petition for supplemental relief and remanded the cause to the District Court for further proceedings to adjust the maturities of the demand loans to make them commensurate with IDC's ability to pay. (A28-31)

REASONS FOR DENYING THE WRIT.

1. The petitioner seeks no more than a review of the sufficiency of the evidence and the inferences drawn therefrom. Granting of the writ for this purpose is not warranted. *General Talking Pictures Corp.* v. *Western Electric Co.*, 304 U. S. 175, 178 (1938); *Southern Power Co.* v. *North Carolina Public Service Co.*, 263 U. S. 508, 509 (1924). The wisdom of this Court's long-standing policy of declining to grant the writ merely to review the sufficiency of the evidence, or inferences therefrom, is well illustrated here. Due to petitioner's persistent argument that the Seventh Circuit improperly viewed the evidence, respondents have been compelled to refer often and in detail to the record, necessarily prolonging this brief, and, with extreme reluctance, imposing an otherwise avoidable burden on the time of this Court.

2. The court below adhered to the accepted and usual course of judicial proceedings in examining the trial record to determine if the judgment of the District Court should be affirmed on grounds other than those relied on by that court. *Dandridge* v. *Williams*, 397 U. S. 471, 475 n. 6 (1970); *Jaffke* v. *Dunham*, 352 U. S. 280, 281 (1957); *United States* v. *American Railway Express Co.*, 265 U. S. 425, 435-36 (1924). Petitioner's argument to the contrary is inconsistent with its position in the court below and is improperly raised for the first time in its petition for certiorari. *United States* v. *Ortiz*, 422 U. S. 891, 898 (1975); *Tacon* v. *Arizona*, 410 U. S. 351, 352 (1973); *Adickes* v. *Kress & Co.*, 398 U. S. 144, 147 n. 2 (1970).

3. The decision of the court below carefully considered and followed the controlling decisions of this Court on the issues of both liability and relief. *Ernst & Ernst* v. *Hochfelder*,

425 U. S. 185 (1976); *TSC Industries* v. *Northway, Inc.*, 426 U. S. 438 (1976); *Santa Fe Industries* v. *Green*, 430 U. S. 462 (1977); *Mills* v. *Electric Auto-Lite Company*, 396 U. S. 375 (1970). No important issue involving the administration of the federal securities laws is raised by the petition. Compare *Santa Fe Industries, Inc.* v. *Green, supra* at 470-471.

4. The court below did not decide the case on the ground of vicarious liability; hence, any supposed conflict between the circuits on the standard of liability under Section 20(a) of the Securities Exchange Act of 1934 is not pertinent here. Even if it were, petitioner argues no more than that the evidence established its statutory defense to controlling person liability under Section 20(a); thus again, petitioner raises only a dispute over the sufficiency of the evidence and inferences drawn therefrom.

ARGUMENT.

I.

THE COURT OF APPEALS FOLLOWED PROPER PROCEDURE IN AFFIRMING THE DISTRICT COURT WITHOUT REMAND FOR RECONSIDERATION BY THAT COURT. PETITIONER CANNOT RAISE THIS ISSUE FOR THE FIRST TIME IN THIS COURT.

A. The Procedure Followed Was Proper.

The court below acted properly in reviewing the record and affirming the District Court on grounds other than those relied on by that court. *Dandridge* v. *Williams*, 397 U. S. 471, 475 n. 6 (1970); *United States* v. *American Railway Express Company*, 265 U. S. 425, 435-36 (1924). As the successful parties in the District Court, respondents may properly sustain their judgment on any ground supported by the record. *Jaffke* v. *Dunham*, 352 U. S. 280, 281 (1957).

It may be noted that on the same day that the court below heard oral argument in the present case, the identical panel also heard oral argument in *Sanders* v. *John Nuveen & Co., Inc.*, 554 F. 2d 790 (1977). *Sanders* had been remanded by this Court to the Court of Appeals for further consideration in light of *Ernst & Ernst* v. *Hochfelder*. In compliance with this direction the Court of Appeals reviewed the full trial record in that 10b-5 case to determine whether there was sufficient evidence to sustain a finding of reckless behavior by defendant, and concluded that there was not. (*Id.* at 793)

If this Court had felt that proper procedure required reconsideration by the District Court in the first instance, presumably such instruction would have been included in the *Sanders* mandate.

B. Petitioner Should Not Be Permitted to Raise the Issue of Remand for the First Time in This Court.

Petitioner contends that the court below should have remanded the case for reconsideration by the District Court because "the whole framework of the litigation ha[d] been altered by several intervening decisions of a higher court . . ." (Pet. 14) Petitioner made no such argument below. To the contrary, in its opening brief below petitioner stated:

> "Because all issues were fully aired at trial and this appeal raises purely legal issues, *there is no need to remand the case upon reversal by this court.*" Heizer Opening Brief, p. 68. (Emphasis added.)

Petitioner also urged in the conclusion of its 67-page post-trial memorandum, filed in the District Court, that deception and fraud were essential elements of 10b-5 liability and that the facts adduced at trial failed to prove either. (R. 80, p. 67)

Petitioner specifically invited the Court of Appeals to review the trial record on the issues of both nondisclosure and scienter, citing *Hochfelder;* expressly noting this Court's grant of certiorari in *Green* (Heizer Opening Brief, pp. 33-42; Heizer Reply Brief, pp. 5-13; 19-20); and citing this Court's ultimate decision therein reversing the Second Circuit Court of Appeals.[13]

In its petition for rehearing in the court below, petitioner expressly stated: "This petition does not question the court's analysis of liability under Rule 10b-5, although Heizer respectfully disagrees with the court's holding in that regard." (Heizer Pet. for Rehrng., p. 2)

Having never raised the question of remand in the Court of Appeals, and, indeed, having taken a contrary position in that court,[14] petitioner may not raise the issue for the first time in its

13. While the appeal in this case was *sub judice,* petitioner brought this Court's decision in *Green* to the panel's attention pursuant to Circuit Rule 11, by letter dated March 31, 1977.

14. Petitioner's briefs in the court below contain extensive analysis and argument of the trial court record. *E.g.*, "From only a

(Footnote continued on next page.)

petition for certiorari. *United States* v. *Ortiz,* 422 U. S. 891, 898 (1975); *Tacon* v. *Arizona,* 410 U. S. 351, 352 (1973); *Adickes* v. *Kress & Co.,* 398 U. S. 144, 147 n. 2 (1970).

II.

THE COURT BELOW CONSIDERED AND FOLLOWED ERNST & ERNST v. HOCHFELDER, SANTA FE INDUSTRIES v. GREEN AND TSC INDUSTRIES v. NORTHWAY, INC. IN DETERMINING LIABILITY.

A. The Fourth Transaction.

1. Scienter.

Petitioner does not dispute in this Court that "recklessness" may properly be considered the equivalent of scienter for purposes of Rule 10b-5.[15] Indeed, it fails to point to anything in the lower court's opinion which conflicts in any way with *Hochfelder.* Its argument on the scienter question, realistically viewed, actually disputes only the sufficiency of the evidence to support the finding below that it acted recklessly. (Pet. 15-20) The writ should not be granted merely to review the sufficiency of the evidence. *General Talking Picture Corp.* v. *Western Electric Co.,* 304 U. S. 175, 178 (1938); *Southern Power Co.* v. *North Carolina Public Service Co.,* 263 U. S. 508, 509 (1924).

But even if this Court were to indulge petitioner's demand that the evidence be reviewed, petitioner has failed to demonstrate that the findings of the court below were clearly erroneous.

(Footnote continued from preceding page.)

brief review of the undisputed facts, this Court can see that there was direct disclosure of all material terms of all financings to the overwhelming majority of the IDC common stockholders as well as the entire IDC board of directors." Heizer Reply Brief, p. 10. And see petitioner's detailed analysis of the trial testimony on deception, scienter and control, *Id.* at pp. 9-20.

15. The Second and Third Circuits have similarly interpreted the scienter prerequisite for Rule 10b-5 liability. *Coleco Industries, Inc.* v. *Berman,* CCH Fed. Sec. L. Rep. ¶ 96,253 (3d Cir. 1977) [current binder]; *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath,* 540 F. 2d 27, 36-37 (2d Cir. 1976).

In its opinion the Court of Appeals noted that the District Court had characterized petitioner's conduct in the fourth (as well as the fifth) transaction as "rapacious," but had made no other findings concerning petitioner's mental state (A25). It did not dispute the District Court's finding of rapaciousness,[16] and stated that "The record, however, indicates that defendant's omissions were at least reckless." (*Id.*)

In arriving at this finding the court below began its analysis with recognition of this Court's decision in *Hochfelder*, defining scienter "to exclude mere negligence." (*Id.*) Noting that this Court left open the question of whether reckless behavior was enough, the court, relying on its earlier decision in *Sundstrand Corp.* v. *Sun Chemical Corp.*, 553 F. 2d 1033 (1977) *cert. denied*, ... U. S. ....., 46 USLW 3207 (1977), held that it was. It also cited its contemporaneous decision in *Sanders* v. *John Nuveen & Co., Inc.*, 554 F. 2d 790 (1977), which rejected any liberal standard of reckless behavior. Thus the court below had firmly in mind the standards to be applied when it examined the record in the District Court.

Petitioner strenuously disputes the lower court's analysis of the evidence, and particularly the inferences drawn therefrom. Petitioner would have this Court review the entire record and make findings, contrary to those made below, that (1) petitioner acted on a reasonable belief that full disclosure of all material facts of the fourth transaction had been made; and (2) that petitioner acted in good faith reliance on independent counsel.

The evidence does not and could not support such findings. Rather, when the following undisputed facts are added to those specifically enumerated by the court below (A17-18, 25-26), a finding not merely of reckless conduct but of intent to defraud would be appropriate:

16. Rapacious is defined as "excessively grasping or covetous; given to seizing or extorting what is coveted; subsisting on prey; predaceous." *Webster's Collegiate Dictionary* (1960).

a) At the time of the fourth transaction petitioner was in control of IDC. (Trial Tr. 688)[17]

b) At that time, petitioner's valuation committee valued IDC common stock at $3.60 per share. (PX 48) The record is bare of any evidence that this fact was ever disclosed by petitioner to Jordon Ross when he obtained signatures on the consent forms from the common stockholders although petitioner knew Ross was going to obtain these consents. (Trial Tr. 1146-47) Nor is there any evidence that petitioner ever disclosed its valuation of IDC common stock to Bernard Kury, its counsel, to whom it delegated the task of overseeing the approval procedure. (A25.)

c) The $1.00 per share conversion price of the notes issued in the fourth transaction was not based on any standard valuation criterion (Trial Tr. 695-698), but was fixed by petitioner for the purpose of triggering the anti-dilution clauses in its earlier warrants in order to equalize its pro forma equity with its total investment (Trial Tr. 701). There was no evidence of disclosure of these facts to Bernard Kury, petitioner's counsel, or to Jordon Ross, or of any knowledge of these facts by Kury or Ross, and thus no evidence that petitioner could reasonably have believed that Ross would communicate this information to the consenting stockholders.

d) Petitioner knew that there was virtually no chance that IDC could repay the loans by their maturity date of March 31, 1972 (A49), and thus it knew that triggering

17. Petitioner's statement (Pet. 15) that it was "clearly not in control of the board of directors or the management of IDC" is disingenuous. Jordon Ross testified that he voted in favor of the fourth transaction only because otherwise petitioner would have called its note and forced IDC into bankruptcy. (Trial Tr. 325-326) Under the terms of its earlier agreements with petitioner, IDC could not change the nature of its business without petitioner's consent. (PX 1, § 2.5) If it failed to obtain financing in the fourth transaction, IDC would have had to discontinue the monitoring business, thus occasioning a default; such default would have given petitioner the immediate right to elect a majority of IDC's directors. (PX 10, Certificate of Amendment of Certificate of Incorporation, Art. Fourth I, 4(B).)

of the antidilution clauses was inevitable.[18] There is no evidence that petitioner ever disclosed these facts to Kury, whom it charged with overseeing the approval procedure, or that he had any independent knowledge thereof.

e) Petitioner, through its representatives in IDC's board, knew that Ross had obtained common stockholder consent to the fourth transaction *prior* to director approval of the transaction and *prior* to completion of drafting of the agreement (Trial Tr. 1144-45, 1778, 1784-1785; DX 93, p. 3). As previously noted, petitioner's representatives on IDC's board of directors voted to amend the by-laws of IDC precisely in order to validate these consents. (*supra* at p. 9). Thus, petitioner could not reasonably have believed that Ross could have delivered any documents to the consenting stockholders fully disclosing the terms and conditions thereof.

Given the undisputed facts that the transaction was virtually certain to result in petitioner's acquisition of a claim on 87% of IDC's equity at $1.00 per share; that *only* petitioner knew that this warrant exercise price was fraudulently low in light of its own expert, internal valuation of $3.60 per share; and that *only* petitioner knew that the transaction was designed to trigger the antidilution clauses of its pre-existing warrants; petitioner's factual argument here that it "reasonably believed that any required disclosure had been made" (Pet. 18) is unsupportable. To the contrary, concealment of these facts, as well as those enumerated by the court below, from the consenting stockholders was so highly unreasonable and such an extreme departure from the standards of ordinary care that petitioner had to know of the danger that the stockholders would be misled.

18. The suggestion that petitioner acted in good faith in the fourth transaction because it expected its loans to be repaid prior to March 31, 1972, out of interim financing for which McCormick & Co. was then "looking," (Pet. 9-11) is belied by petitioner's conduct on March 13, 1972. On this date, petitioner loaned IDC another $105,000, on terms governed by the November 19, 1971 agreement. By then, McCormick was no longer trying to find financing, and petitioner admitted that there was no chance of IDC repaying this loan by March 31, 1972. (Trial Tr. 732)

The court below correctly found that, based on the record, petitioner's conduct "was at least reckless." (A25-26)

Nor does the record support petitioner's argument that it "knew that holders of a majority of the stock were fully informed." (Pet. 18) Kury, petitioner's agent, testified that he recollected seeing the consents after they were executed and before the transaction was closed and "adding up the numbers to make certain that an appropriate number of votes were represented by the consents." (Trial Tr. 1146) On their face the consents (PX 16) show that Ross held only 265,800 shares, or approximately 32%, and that neither DeKraker nor Johnston (owning 7% in the aggregate) consented. There is no evidence in the record that Ross actually controlled any more than the 32% which he owned.[19] Nor is there any evidence that any of the other consenting stockholders had any information respecting the transaction, except IDC's counsel (Sigal's law firm) and LaBow, who together owned but three per cent. Thus, contrary to petitioner's assertion (at Pet. 18n* and n.**), the consenting stockholders who might have had knowledge of the transaction owned only 35% of the common stock; and Ross, who owned virtually all of this amount, did not know of petitioner's internal valuation of the stock or its scheme to trigger the antidilution clauses in its warrants.[20]

Petitioner's second contention, that it relied on counsel, and, therefore, could not possess the requisite scienter, is strictly a

19. PX 66, upon which petitioner relies, shows Ross as owning 348,900 shares. This document was prepared by Heizer Corporation, not IDC or Ross. As it conflicts with PX 16, the consent actually signed by Ross, PX 66 must be disregarded.

20. Petitioner's further attempt to buttress its claimed reasonable belief that "any required disclosure had been made" by pointing to the legal opinion issued by IDC's counsel (Pet. 18), is audacious. IDC's counsel admitted that petitioner's counsel participated in drafting the critical language of that opinion. (Trial Tr. 1787-1788) This being the case, petitioner should not assert, even by implication, that it relied in good faith upon that opinion as an opinion of *independent* counsel. In any event, that opinion says nothing at all about disclosure of the terms of the fourth transaction to anyone.

defense, which, if not required to be pleaded as an affirmative defense, at least must be proved at trial by the defendant asserting it. Petitioner did neither. It failed to plead or otherwise raise this defense either in the trial court or in the court below, and now appears to do so as an afterthought. But petitioner's own authorities (Pet. 16-17), require a defendant, at a minimum to prove, *inter alia*, that there was actual reliance on an erroneous opinion of counsel, and that a full disclosure of all material and relevant facts was made to counsel rendering the opinion. *Hawes & Sherrard*, "Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases," 62 *Va. L. Rev.* 1, 19, 29, 38-39 (1976). A further element of the defense is that the opinion sought must be on a complex legal question requiring expertise not possessed by defendant; reliance on the attorney to perform certain acts or otherwise serve as agent or delegee of defendant is wholly insufficient to negate scienter. *Hawes & Sherrard, supra*, at 101, 115, 128, and cases cited therein.

On every one of the above elements of proof, the record ridicules petitioner's belated "reliance on counsel" claim. It did not seek or obtain from counsel a legal opinion on the adequacy of disclosure to IDC's shareholders; it merely delegated to an agent, who happened to be its attorney, the task of obtaining stockholder consents. The record is devoid of evidence that petitioner itself ever disclosed to Kury, its counsel, all material facts relative to the fourth transaction, *e.g.*, its valuation of IDC stock and intentional triggering of the antidilution clauses of its warrants, see text, *supra*, at 21-22. Petitioner was a specialist in investing in the securities of other companies (A44), and, being owned itself by public investors (banks, pension funds, universities) (A5), did not and could not prove that fair disclosure of the fourth transaction was so complex and so far beyond its own expertise as to require, let alone justify, total reliance on counsel.

Plainly recognizing that it failed to plead, prove, or even argue this defense below, petitioner boldly tries to shift the

burden of proof on the issue to respondents. It asserts, utterly without support in the authorities cited, Pet. 16-17, that "there can be no finding of scienter absent affirmative evidence of some knowledge on the part of the defendant that the attorney would probably act improperly." (Pet. 16) Petitioner then includes in its catalogue of "evidence" challenging the lower court's finding of reckless conduct, the statement, "the attorney on whom petitioner principally relied had acted with demonstrated care in the past." (Pet. 20) Both petitioner's purported legal rule and its contention of fact based thereon are merely efforts to finesse fatal weaknesses in its evidentiary attack on the lower court's holding. The writ should not be granted to review such shallow claims of error.

2. Vicarious Liability.

Neither the District Court nor the court below based its finding of liability in the fourth transaction on Section 20(a) of the Securities Exchange Act of 1934, 15 U. S. C. 78t(a) ("controlling persons"), or the common law doctrine of *respondeat superior*. Nevertheless, petitioner raises a straw man and argues that *"if"* the court below intended a finding of vicarious liability, such finding was error because the evidence "could have sustained" the statutory defense provided in Section 20(a).[21] (Pet. 20-21)

Petitioner then argues that, because evidence of the statutory defense was ignored, the court below must have based its finding of liability on the common law doctrine of *respondeat superior*, in conflict with other circuits, a conflict which should now be resolved in this case. (Pet. 21)

The simple answer to this attentuated argument is that this Court does not sit to adjudicate hypothetical questions. However,

21. ". . . unless the controlling person acted in good faith *and* did not directly or indirectly induce the act or acts constituting the violation or cause of action." (Emphasis supplied.)

assuming *arguendo* that the Court of Appeals intended a finding of vicarious liability, petitioner's point again reduces to no more than an evidentiary dispute. The predicate of petitioner's argument is that the evidence established a defense under Section 20(a). If it did not, then the question whether the doctrine of *respondeat superior* was improperly applied becomes irrelevant and need not be decided by this Court in this case.

The court below found that petitioner was IDC's controlling stockholder who chose to participate in communications to the IDC stockholders. (A18-19) These facts are not in dispute. The court's conclusion that as a fiduciary petitioner owed the stockholders "the duty of full disclosure" (A19) is hardly arguable, especially in a self-dealing transaction between petitioner and IDC. Nor can there be any dispute that Kury, petitioner's agent, at petitioner's direction, and with its knowledge and approval, directly participated in and arranged for the consents to the fourth transaction.[22] (A18, A25-26) Accordingly, there is ample evidence that petitioner, as a controlling person, directly or indirectly, *induced* the uninformed consents from IDC's independent common stockholders; there is no evidence to the contrary.

Respondent has heretofore addressed the question of petitioner's asserted "good faith" in the fourth transaction. (Pages 20-23, *supra*) But having failed to establish one leg of its defense —that it *"did not* directly or indirectly *induce* the act or acts constituting violation"—the other leg, "good faith" becomes immaterial. The statutory defense is in the conjunctive: unless *both* elements are satisfied, the defense must fail.

Moreover, where the transaction is for the benefit of the controlling person, actual knowledge of the specific wrongdoing

22. Viewed from the perspective of Section 20(a), Ross too may properly be considered to have been petitioner's "controlled person" at the time of the fourth transaction. At that time Ross was Chairman of the board of IDC (PX 59). The statute requires "only some indirect means of discipline or influence short of actual direction to hold a 'controlling person' liable." *Myzel* v. *Fields,* 386 F. 2d 718, 738 (8th Cir. 1967), *cert. denied,* 390 U. S. 951 (1968).

need not be shown; it is sufficient that the controlling person directly or indirectly induced the transaction. Otherwise, Section 20(b) of the Act[23] would be vitiated. *Myzel* v. *Fields,* 386 F. 2d 718, 738-39 (8th Cir. 1976), *cert. denied,* 390 U. S. 951 (1968).

B. The Fifth Transaction.[24]

1. Scienter.

By the time of the undisclosed fifth transaction, petitioner was in control of IDC's board of directors. (A19) The District Court found that petitioner's conduct in that transaction "was even more rapacious" (A64) The Court of Appeals found that it "bespeaks a reckless disregard of its duty to disclose" because the pledge was for its benefit and thus would arouse a great deal of opposition. "Yet it *consciously* decided, through Heizer counsel, not to take the proposal to the shareholders." (A26). (Emphasis added.)

Petitioner suggests that these are findings of no more than a breach of fiduciary duty, not scienter (Pet. 23), as if the former necessarily excluded the latter. What petitioner would ignore, but what the court below expressly noted, is that the fifth transaction was designed by petitioner to thwart the pending lawsuit and make it impossible for the District Court to grant

23. "(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person."

24. Petitioner suggests that the only securities involved in the fifth transaction were short-term notes, and therefore no purchase or sale of a "security" was involved. (Pet. 22n.*) Petitioner ignores the fact that in that transaction IDC conveyed all of the stock of its subsidiary to petitioner by a pledge under which IDC surrendered all voting rights to the stock, and under circumstances where default thereunder was a virtual certainty. (PX 25; A64) Thus in reality IDC parted with its entire interest in the stock of T & R. Such transaction was well within the statutory definition of a sale. 15 U. S. C. 78(c)(14). In any event, since there were independent grounds for voiding the pledge (A27-28), this Court need not consider the question whether the notes were securities. See page 33, *infra.*

any effective relief should plaintiffs prevail. (A12, 24, 26) These facts are not disputed. Concealment of the pledge, and especially its true purpose, was *essential* to petitioner's scheme. Accordingly, the finding of the court below that petitioner *consciously* decided not to take the proposal to the shareholders is amply supported by the evidence. While the court characterized petitioner's conduct as reckless, it comes well within the definition of scienter, "a mental state embracing intent to deceive. . . ." *Ernst & Ernst* v. *Hochfelder*, 425 U. S. 185, 193 n. 12 (1976).

Further evidence of petitioner's intentional deception may be found in its subsequent conduct. Two months after the pledge, IDC's president wrote to the stockholders reporting on past and current operations. Buried on the fifth page of that seven-page letter was a single paragraph disclosing the pledge.[25] No disclosure was made (a) of the true purpose of the pledge (*i.e.*, to insulate petitioner from the possible adverse outcome of the litigation); (b) of the total amount of indebtedness secured and to be secured thereby; (c) of the fact that there was no possibility of repayment of this indebtedness by January 2, 1974; or (d) of the value of the asset pledged. Thus, even when it decided to reveal the existence of the pledge, petitioner

25. "As soon as possible we plan to present specific financing plans to the stockholders for their consideration.

"In the meantime, the Company needs funds to support the monitoring program recommended by management. The Heizer Corporation is willing to continue to provide such funds. However, in the light of current law suits, Heizer Corporation requested that T&R stock be pledged as security for non-equity demand debt now owed to Heizer Corporation and such additional funds as may be advanced by Heizer Corporation in 1973. Accordingly, in June, 1973, the Company entered into an agreement with Heizer Corporation whereby the Company pledged the stock of T&R in return for Heizer Corporation's agreement to extend the Company's current debt until the end of the year provided that the Company's stockholders approve the financing plans to be submitted to them, and to advance additional funds during 1973 provided the Company meets certain projections. It is our hope that this will enable the Company to carry on the monitoring program and to complete its financing plans." (PX 53, p. 5)

carefully concealed its material terms in order to avoid any adverse response from the common stockholders.

Under the foregoing circumstances, application by the court below of the reasoning in *Bailey* v. *Meister Brau, Inc.*, 535 F. 2d 982, 993-94 (7th Cir. 1976), was particularly appropriate. Petitioner's conflict of interest was so glaring as to be blinding; disregard of the unfairness of the pledge, and failure to make disclosure thereof, can only be described as wanton.[26]

2. Deception.

Petitioner does not dispute the fact that there was no disclosure to the independent shareholders of IDC of any of the terms of the fifth transaction prior to its consummation. It admitted as much in its answer (R. 63, ¶ 25), and the court below so found. (A20) Nor does petitioner quarrel with the holding of the court below that disclosure was required because these facts were material. (A21-24) Petitioner merely contends that, since it made *subsequent* disclosure, before the transaction had become "irrevocable," its failure to make prior disclosure was excused.[27] (A24)

Petitioner's attack on the reasoning of the court below is erroneous both as a matter of fact and law.

Contrary to petitioner's assertion (A24), the Court of Appeals did *not* conclude "that there was reasonably prompt disclosure of the transaction to the stockholders after it was approved." What the court said was that "the shareholders were first informed of the *general terms* of the pledge and the reasons therefor two months after the transaction." (A20-21). (Emphasis

26. Reliance by petitioner on *Cole* v. *Schenley Industries, Inc.*, CCH Fed. Sec. L. Rep. ¶ 96,166 (2d Cir. 1977) (Pet. 23) is misplaced. Contrary to the present case, the court there expressly found that there had been full disclosure of the material facts. (*Id.* at p. 92,288)

27. In its answer to the second amended complaint petitioner admitted that there was no disclosure of the terms of the fifth transaction either before or *after* its consummation. (R. 63, ¶ 25)

added.) But that information contained in a single paragraph of a seven-page letter from IDC's president (reproduced in pertinent part, *supra*, note 26) was, as heretofore shown, more deceptive than informative. The record is bare of any evidence that petitioner, or IDC, ever informed the shareholders of all of the material terms of the pledge, including petitioner's true purpose in extracting it from IDC.[28] Absent the fundamental premise of petitioner's argument, that there was reasonably prompt and adequate disclosure of the transaction after its consummation, petitioner's conclusion is fatally flawed. In sum, petitioner is asking this Court to decide yet another purely hypothetical question: whether, *assuming* prompt and full disclosure after the transaction, petitioner's statutory duty under Section 10(b) was discharged.

The balance of petitioner's defense of the fifth transaction relies on a distortion of this Court's reasoning in *Green*. There, in addressing itself to the *materiality* of the alleged nondisclosure, this Court concluded that, since the shareholders could not have prevented the transaction, even in a state court injunction proceeding, prior disclosure would have been meaningless and, therefore, the information allegedly concealed was not material; hence advance notice was not required. 430 U. S. at 474 n. 14. The court below followed this reasoning in determining that, in the present case, the terms of the fifth transaction were material and that prior disclosure was required, since respondents could have obtained a state court injunction to enjoin the transaction. (A21-22).

Petitioner seizes upon this narrow holding on the issue of materiality and would transform it into a general proposition that disclosure of material facts required under Section 10(b)

28. The pledge was consummated in June, 1973. The case was tried in March, 1974. Petitioner introduced no evidence at trial of any post-transaction disclosure of either the terms of the pledge or the reasons for its existence. Plaintiffs' knowledge of the terms of the pledge and related facts was obtained through discovery in the present case.

may be made *at any time*, at the option of the defendant, even months after the transaction, so long as it has not become "irrevocable."[29] (Pet. 24) Petitioner's peculiar reading of *Green* totally ignores the specific language of Section 10(b), as well as Rule 10b-5, which requires disclosure *"in connection with"* the securities transaction. But, the starting point in every case involving construction of a statute is the language itself. *Ernst & Ernst* v. *Hochfelder*, *supra*, at 197. Petitioner leaves unexplained how disclosure can be made months after conclusion of a transaction, and still be "in connection" therewith.

The gravamen of the decision below was not, as petitioner argues, mere breach of fiduciary duty by a controlling shareholder (A24), but intentional concealment of material facts from the corporation's independent shareholders when a duty of disclosure existed. That the transaction may also have amounted to a common law breach of fiduciary duty can hardly stand as a reason for denying respondents a remedy under Section 10(b). *Goldberg* v. *Meridor*, CCH Fed. Sec. L. Rep. ¶ 96,162 (2d Cir. 1977), [current binder]. *Only* when full and fair disclosure has been made is the fairness of the transaction reduced to tangential concern of the statute. *Santa Fe Industries* v. *Green*, *supra*, at 478.

3. Causation.

Petitioner's criticism of the lower court's finding of causation[30] parallels its challenge to the finding of deception. Petitioner perceives some unarticulated error in the court's reasoning because it "inextricably intertwined the concepts of fiduciary

29. Petitioner does not define the term "irrevocable" in this context, but its argument suggests a post-transaction time frame beyond which equitable relief voiding the transaction would not be available in a state court. There is nothing in the record in the present case which establishes that, in a *state court proceeding*, brought months after the fifth transaction, and doubtlessly adjudicated many months after that, a chancellor would necessarily have granted such relief at the instance of an independent shareholder of IDC.

30. The Court of Appeals discussed this question in terms of both reliance and causation. (A21-24)

duty and state corporate common law with the federal securities laws . . ." (A 26)

The argument that breach of fiduciary duty on the one hand, and securities fraud on the other, are mutually exclusive concepts is irrational. In the real world transgressions are not subject to such simple separation and labeling. "The Congress made clear that 'disregard of trust relationships by those whom the law should regard as fiduciaries are all a single seamless web' along with manipulation, investor's ignorance, and the like." *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U. S. 6, 11-12 (1971). "[T]he statute provides a cause of action for any plaintiff who 'suffer[s] an injury as a result of deceptive practices touching its sale [or purchase] of securities . . .'" *Santa Fe Industries, Inc.* v. *Green, supra,* at 476, quoting *Superintendent of Insurance, supra.*

Thus, as this Court has twice said, deception in a securities transaction is not removed from the reach of the statute merely because, in committing the fraud, the defendant also breached his common law fiduciary duty.

The court below related its finding of reliance to its finding of materiality. Applying this Court's decision in *Affiliated Ute Citizens* v. *United States*, 406 U. S. 128, 153 (1972) the court held that if the omitted information was material, reliance is presumed. (A21) As above argued (p. 30), in determining materiality in the context of the fifth transaction, the court first made the necessary finding that, given advance disclosure of the information, the independent shareholders would not have been powerless to prevent the transaction. It was only in this narrow context that the court directed its inquiry to the fairness of the transaction to determine whether a "causal link" existed between the nondisclosure and consummation of the transaction. (A22)

Petitioner's unjustified criticism is bottomed on its misreading of the lower court's opinion. Nowhere in its opinion did the court below depart from the teaching of *Green* that deception

is a necessary element of Section 10(b) liability. Nor, in light of the command in *Green*, could it have grounded its finding of liability on a breach of fiduciary duty and nothing more. To the contrary, upon careful analysis the court expressly found that the record proved each element of Section 10(b) liability: nondisclosure; materiality; scienter; reliance; and causation. Once again petitioner is disputing nothing more than the sufficiency of the evidence to prove these elements.

4. Alternative Grounds for Relief.

The Court of Appeals held the pledge void even if petitioner's conduct in the fifth transaction "was not in itself actionable under Rule 10b-5." (A27) It was undisputed that the purpose of the pledge was to insulate petitioner from liability in the event it was found to have deceived the corporation in the other transactions, and the court below so found. (*Id.*) Accordingly, because it was a consequence of petitioner's statutory violation in the fourth transaction, the court found it to be void on this wholly independent ground. (A27-28)

Petitioner nowhere challenges this independent ground for relief in the fifth transaction, except to the extent that it disputes liability in the fourth transaction. Accordingly, if the lower court's finding of liability in the fourth transaction was correct, petitioner must be deemed to have admitted liability in the fifth, irrespective of any claimed absence of deception and scienter therein.

III.

THE ISSUES RAISED IN THE PETITION RESPECTING RELIEF WERE NEVER RAISED BELOW. THE RELIEF GRANTED WAS WELL WITHIN THE STATUTORY AND EQUITY POWERS OF A FEDERAL COURT.

A. The Issues Are Raised for the First Time in the Petition.

Petitioner argues that in changing the convertible notes to nonconvertible notes, and in extending the maturities of the demand loans, both courts below exceeded their statutory

powers. In petitioner's view the statute provides for either damages or total rescission, but does not permit reformation. (Pet. 27-29) Petitioner also urges that, with respect to the prospective relief granted, neither court below made the requisite findings of irreparable injury or inadequacy of a remedy at law. (Pet. 30)

Petitioner raised neither of these issues below.[31] Having failed to do so, it should not be permitted to raise them for the first time in this Court, *United States* v. *Ortiz, supra; Tacon* v. *Arizona, supra; Adickes* v. *Kress & Co., supra.*

B. The Relief Granted Was Within the Power of the Lower Courts.

1. Reformation of the Convertible Notes and Demand Loans.

Petitioner's argument that the lower courts had no power to cancel the convertibility feature of the convertible notes or adjust the maturities of the demand loans is unsupported by any authority. The controlling decisions of this Court are to the contrary.

In *Mills* v. *Electric Auto-Lite Co.*, 396 U. S. 375, 386 (1970) this Court said:

> "In selecting a remedy the lower courts should exercise 'the sound discretion which guides the determinations of courts of equity,' keeping in mind the role of equity as 'the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims.'"

More recently, in *Rondeau* v. *Mosinee Paper Corp.*, 422 U. S. 49, 63 (1975) this Court affirmed its earlier view in *Deckert*

31. It is true that the relief reforming the demand loans was granted for the first time in the Court of Appeals' modified opinion issued after consideration of petitioner's Petition for Rehearing in that court. But the relief reforming the convertible notes issued in the fourth transaction to nonconvertible notes was granted *in the first instance by the District Court*. Thus the power of the court to order reformation could have been but was not raised by petitioner in the Court of Appeals.

v. *Independence Shares Corp.*, 311 U. S. 282, 288 (1940), that the power of a federal court to make the right of recovery effective under federal securities laws implied the "power to utilize any of the procedures or actions normally available to the litigant according to the exigencies of the particular case."[32] Earlier this Court had said that it is for the federal courts to adjust their remedies so as to grant the necessary relief where federally secured rights are invaded. *J. I. Case Co.* v. *Borak*, 377 U. S. 426, 433 (1964).

Accordingly, while the 1934 Act does permit relief by an award of damages or by voiding a transaction in its entirety, petitioner's argument that these are the *sole* remedies available for violation of the statute is inconsistent with the foregoing decisions of this Court.

The necessity for the adjustment of the notes under the equitable power of the lower courts is clearly demonstrated by the exigencies of this case.

Had the District Court been limited to voiding the fourth transaction in its entirety, no equitable relief[33] at all would have been possible. Voiding the transaction entirely would have required immediate repayment by IDC to petitioner of the full $819,000 consideration received for the convertible notes, a condition that was impossible in light of IDC's cash position. The equitable relief required was the limited reformation excising the conversion feature of the notes, the feature which was the *sine qua non* of petitioner's fraud. Since this was all that was required under the exigencies of the case, this was the relief which the District Court granted.

Insofar as the demand loans were concerned, rescission was even more impossible. Immediate repayment of the entire $5

32. There is nothing in *Deckert* to support petitioner's suggestion (Pet. 28n*) that the case was limited to relief *pendente lite* or ancillary relief.

33. Petitioner never suggested below that money damages be awarded in lieu of equitable relief. Nor does it suggest in this Court how such damages might have been computed.

million in demand loans would have required the liquidation of IDC, the very result which the Court of Appeals had determined that petitioner was to be denied. (A30)

Petitioner's additional complaint that the retrospective relief awarded was punitive (Pet. 28) is plainly specious. Petitioner is no different than any other law violator who has been denied the fruits of his fraud. If such relief is to be deemed "punitive," and thus beyond the limits of the 1934 Act, then those who profit by defrauding others will be licensed to do so by the very statute designed to protect investors against such conduct. It is hardly possible that Congress intended any such result.

Equally specious is petitioner's argument that it has been deprived of its property without due process of law. (Pet. 29) Petitioner has been deprived of nothing except that which it obtained through fraud. It still retains its notes and ultimately should recover their full amounts (A31), including interest.

Finally, petitioner's attempt to plead the doctrine of *in pari delicto* (Pet. 28, n.**) comes too late. It never raised the issue below. Nevertheless, petitioner's reliance on *Tarasi* v. *Pittsburgh National Bank*, 555 F. 2d 1152 (3d Cir. 1977) is misplaced. That case held that the defense of *in pari delicto* barred a Section 10(b) action by a "tippee" against his "tipper." 555 F. 2d at 1164. No such facts are present in this case. The present case is a derivative action in which any violation of law committed by IDC was as a result of petitioner's control. The defense of *in pari delicto* is not available against a plaintiff whose conduct was passive and coerced.[34] 555 F. 2d at 1162.

2. Prospective Relief.

While it made no such argument below, petitioner now belatedly complains that the lower courts did not make findings of "irreparable injury" or "inadequacy of a remedy at law"

34. Jordon Ross was never a party in the case and was not granted any relief by the lower courts. In November, 1977, petitioner sued Ross for contribution, *Heizer Corporation* v. *Jordon Ross*, No. 77 C 4162, N. D. Ill.

in granting prospective injunctive relief. The record shows otherwise.

The District Court granted such prospective relief "because of the dominant position which Heizer holds in relation to IDC and its clear over-reaching in the fourth and fifth transactions." (A66) The Court of Appeals found that "There is sufficient basis for the District Court's determination that some kind of restraint on future abuses is warranted." (A32) It also spelled out its own reasons for determining that prospective relief was necessary. (A32-33) By these findings the lower courts thus necessarily found that, unless restrained, petitioner would inflict irreparable injury on IDC and its common shareholders in the future. Conversely, there was no showing by petitioner that it intended to comply with the law in the future, and indeed, its repeated violations demonstrated that it had no intention of abandoning its buccaneer philosophy. Accordingly, there was some "cognizable danger of recurrent violation" sufficient to warrant the injunction. *United States* v. *W. T. Grant Co.*, 345 U. S. 629, 633 (1953).

Petitioner seems to suggest that, in issuing an injunction, a court is obliged to use the magic words "irreparable injury" and "inadequacy of a remedy at law." No such requirements appear in Rule 65(d), Fed. R. Civ. Pr., and petitioner cites no authority mandating these specific words. All that the Rule requires is that the order granting the injunction "set forth the reasons for its issuance." As shown above, both courts below complied with this requirement.

Nothing in the opinion of either lower court conflicts with *Rondeau* v. *Mosinee Paper Corp.*, 422 U. S. 49 (1975). Neither court excused the traditional requirement that irreparable injury be shown before an injunction may issue under the federal securities laws. Both courts clearly found that petitioner's conduct caused IDC and its common shareholders irreparable injury in the past and threatened such injury in the future. Considering that twice during the course of this litigation petitioner deliber-

ately attempted to subvert the lower courts' jurisdiction,[35] the finding of the Court of Appeals that "some kind of restraint on future abuses is warranted" may be considered an understatement.

Again, petitioner disputes nothing more than the sufficiency of the evidence to support the findings of the lower courts. As heretofore argued, the writ should not be granted merely to review the sufficiency of the evidence.

CONCLUSION.

Petitioner's broad-axe assault on the Seventh Circuit (Pet. 13) is unwarranted and irrelevant to this case. Petitioner cannot disguise the fact that its petition presents no questions worthy of this Court's review. As revealed in its argument, petitioner merely disputes the sufficiency of the evidence supporting the lower court's findings on liability and relief, or raises issues which it failed to argue below.

Respondents respectfully urge that the petition be denied.

Respectfully submitted,

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35. The fifth transaction occurred while the case was pending in the District Court. Petitioner's plan of recapitalization was attempted while the case was on appeal but had been remanded to the District Court for certain limited purposes.